

# *the art of the state*



Volume VI

## Redesigning Canadian Trade Policies for New Global Realities



Edited by Stephen Tapp, Ari Van Assche and Robert Wolfe

### About this chapter

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Stephen Tapp is a research director at the Institute for Research on Public Policy, and is currently leading a multiyear research initiative on Canadian trade policy. Before joining the Institute, he was a senior economist and adviser for Canada's first Parliamentary Budget Officer. He has worked as an economist in the research departments of the Bank of Canada and Finance Canada; as a research fellow at the C.D. Howe Institute; and as an economics instructor at Queen's University. His research, which focuses on the Canadian economy and public policy, has been published in the *Canadian Journal of Economics*, *Canadian Public Policy*, and by think tanks and government organizations. He is on the board of the Ottawa Economics Association. Stephen has a PhD and an MA in economics from Queen's University and a BA from the University of Western Ontario.

*Redesigning Canadian Trade Policies for New Global Realities*, edited by Stephen Tapp, Ari Van Assche and Robert Wolfe, will be the sixth volume of The Art of the State. Thirty leading academics, government researchers, practitioners and stakeholders from Canada and abroad analyze how changes in global commerce, technology, and economic and geopolitical power are affecting Canada and its policy.

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## Going Global: Canadian SME Trade and Emerging Markets

*Sui Sui and Stephen Tapp*

ENCOURAGING INTERNATIONAL TRADE BY SMALL AND MEDIUM-SIZED ENTERPRISES (SMEs) has recently become a focus for trade policy both in Canada and abroad. For advocates, increased SME participation promises to deliver more inclusive economic growth by sharing the gains from international trade more broadly. Concurrently, there is a related policy push in Canada for businesses of all sizes to increase their engagement with fast-growing emerging markets in order to help diversify trade beyond the default US market, which has long been the primary destination for Canadian exports (see Bank of Canada 2013; Head 2007; and Manley and Kingston, in this volume).

Bringing these two aims together, the Harper government made it a policy objective in 2013 to raise the share of Canada's exports to emerging markets significantly, with an increased contribution coming from SMEs (Canada 2013).<sup>1</sup> In 2015, when the new Trudeau government took office, the mandate letter to the minister of international trade identified as a top priority developing "a targeted strategy to promote trade and investment with emerging markets, with particular attention to China and India," and added that this strategy, "should include the mobilization of our SMEs" (Trudeau 2015).

Thus, there is now a clear political consensus both to increase Canada's economic engagement with emerging markets and to boost SMEs' participation in international trade more broadly — particularly in emerging markets. Before considering how to design policies to support these goals, however, it is first necessary to understand the trade patterns of Canadian SMEs, including how they are evolving and how they differ from those of large firms; the size of the performance premiums for Canadian SMEs that export to emerging markets; and the influence of different globalization strategies and firm capabilities on the likelihood of SMEs' success in these markets.

There are grounds for optimism on some of these fronts for policy-makers. Since around 2001, for instance, the share of Canadian exports destined for emerging markets has risen, and these markets have increasingly become the first stop for the export journeys of Canadian firms. Moreover, consistent with predictions from firm-level trade theory (for an overview, see Lapham, in this volume) the larger, more productive and more innovative SMEs are more likely to export to, and survive in, emerging markets.

But we must also add some caution to policy-makers' current enthusiasm: although entering emerging markets might offer bigger rewards for top performers, it generally entails more risk, and can be tremendously challenging, especially for companies that are not well-equipped to compete. Firm-level performance gaps between top and bottom Canadian exporters are particularly pronounced in these markets. Moreover, there is not necessarily a "right way" for Canadian firms to reach emerging markets. In general, the chances of surviving in these markets are better for gradual exporters — older, larger firms that are more experienced in the domestic market and/or that have exported first to other advanced economies. This is not the only recipe for success, however, a smaller number of "born global" firms operating out of Canada have reached emerging markets successfully quite early in their operations. Examples can be found in the higher-technology services sectors.

Research finds that a firm's export survival in emerging markets depends not only on its own capabilities — including how frequently it introduces new products or its access to external financing — but also on broader market factors, including competition for those markets by Canadian rivals. Firm-level decisions to enter emerging markets are therefore quite complex. Each potential exporter may face large, upfront entry costs as well as its own particular and highly uncertain risk-reward tradeoffs from choosing among alternative export strategies.

These considerations highlight at least two important and complementary roles for government policy. The first role is to provide information to help Canadian firms learn about their options in emerging markets, so they can make well-informed decisions based on their unique circumstances. The second, more general role is to lower the costs of entering and engaging with these markets. Government can pursue the latter in a variety of ways, including by negotiating trade and foreign investment agreements that reduce obstacles and improve market access, and by simplifying customs procedures and promoting cross-border electronic commerce.

## Academic Theories of the Export Journey

IN CONTRASTING THE EXPERIENCES OF SEQUENTIAL EXPORTERS AND “BORN GLOBAL” FIRMS, the academic literature highlights two broad exporting pathways.

### Sequential exporters

Theories of sequential exporting arise in international business management and economic trade research. In the former, a theory known as the “internationalization process model” describes how firms gradually increase their international activities (Johanson and Vahlne 1990). After building up a strong presence in the domestic market, firms will often export first to a neighbouring market with a similar cultural background before entering less culturally familiar foreign markets farther away (Johanson and Vahlne 1977; Arenius 2005).

In economics, firm-level trade theory emphasizes other (though somewhat related) factors to explain exporting activities. These reasons include productivity differences between firms, the large fixed costs or “investments” needed to enter foreign markets and the uncertainty associated with these investment decisions (Melitz 2003). This theory predicts — and the empirical evidence generally confirms — that, within a given industry, exporters will be the larger and more productive firms, essentially because they are profitable enough to cover the costs of entering foreign markets. Recent research finds a “virtuous cycle” or two-way relationship underlying these results: not only do “better” firms choose to export, but the act of exporting (and importing) also improves their performance (see the chapter by Baldwin and Yan on global value chain participation, in this volume).<sup>2</sup>

The fixed trade costs that feature prominently in firm-level trade theory also help to explain gradual exporting behaviour. Firms often export first to neighbouring countries because these markets tend to have lower entry costs — say, because of proximity or preferential market access under a free trade agreement. As firms’ exporting activity and profits increase, they can eventually accumulate the resources needed to cover larger investments to enter more “difficult” foreign markets farther away.<sup>3</sup>

### Born global firms

In the 1990s, however, international business studies began reporting quite different findings. This new literature identified firms that were “born global” —

or “international new ventures.” Instead of sequentially exporting in a slow and steady manner, these firms derived competitive advantage by using resources from, and selling outputs to, multiple countries at the same time (Oviatt and McDougall 1994). The emergence of these born global firms has been attributed to several factors, including lower communication costs, more efficient global transportation networks and more liberal trade policies (Fan and Phan 2007). Interestingly, born global firms do not necessarily first enter countries that are culturally closer (Benito and Gripsrud 1992), nor are they more successful when they do so (Evans, Lane and O’Grady 1992; Mitchell, Shaver and Yeung 1994).<sup>4</sup>

An insight from this research is the importance of a firm’s information and systems processes and that these systems generally differ between young and old firms. Older firms that have served only their domestic market will have developed routines and modes of operating that are well-suited to that market, but not to an international environment, leaving them having to “unlearn” established approaches in order to succeed abroad (Santangelo and Meyer 2011). Younger firms are less likely to have developed highly structured operating processes and are better able to incorporate new knowledge from the foreign markets they enter into their business practices (Bruneel, Yli-Renko and Clarysse 2010; De Clercq et al. 2012; Sapienza, DeClercq and Sandberg 2005; Blomstermo, Eriksson and Sharma 2004).

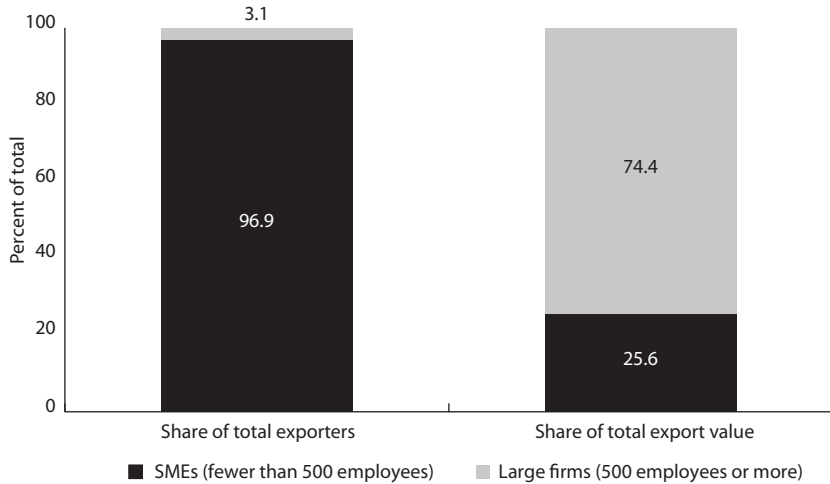
## **Canadian SMEs’ Exports, according to Transactions Data**

THE EXPORTING ACTIVITIES OF CANADIAN SMEs — DEFINED AS FIRMS WITH FEWER THAN 500 employees — can be measured in various ways: by transactions data, firm-level surveys or longitudinal data, each with its own strengths and weaknesses.<sup>5</sup> Assembling the evidence from all these sources thus provides a more comprehensive look at Canadian SME trade.

### **SMEs’ contribution to goods exports**

We begin with a detailed snapshot of the recent goods-exporting activities of Canadian firms, reported by employment size, using Statistics Canada’s export transactions data. In 2014, more than 41,000 goods-exporting enterprises were operating in Canada;<sup>6</sup> 97 percent of them were SMEs — see figure 1. Export revenues, however, were highly concentrated among a handful

Figure 1

**Shares of total goods exporters and total value of exports by SMEs and large enterprises, Canada, 2014**

Source: Authors' calculations using Statistics Canada's Trade by Enterprise Characteristics Program, 2014 provisional estimates.

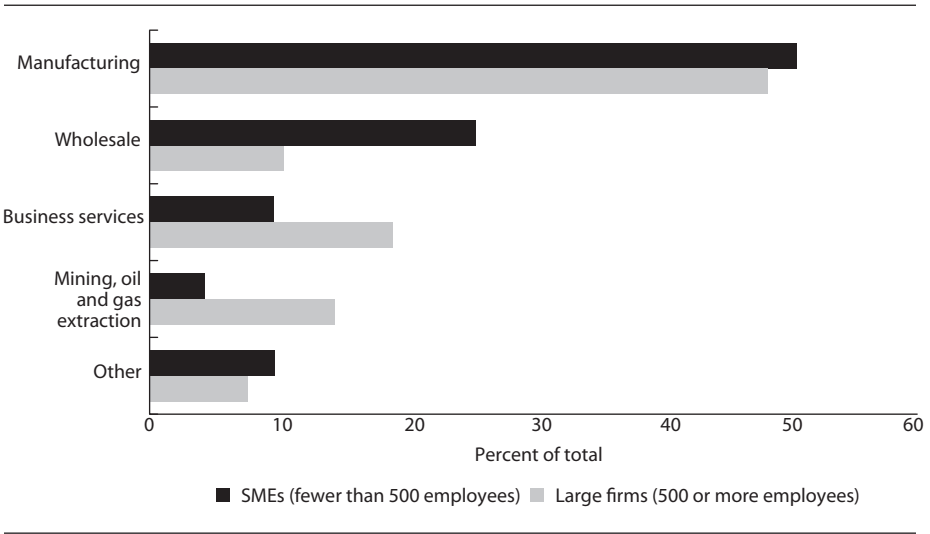
of large firms,<sup>7</sup> which averaged \$276,809, compared with only \$2,995, on average, for SMEs. Nonetheless, many SMEs are active *direct* exporters, collectively contributing about one-quarter of the total value of Canada's exports — leaving aside *indirect* contributions by small firms that act as domestic suppliers to large firms that subsequent export.

### Goods exports by sector and firm size

For both SMEs and large firms, manufacturing is by far the largest exporting sector, responsible for roughly half of the value of all Canadian goods exports (figure 2). For SMEs, wholesale trade is the second most important export industry, followed by business services.<sup>8</sup> Wholesale trade, however, has a lower average export value than do sectors such as mining, oil and gas extraction, transportation equipment, and finance and insurance, where large firms predominate. In 2014, if the SME export basket had had the same industrial composition as that of large firms, the value of total SME exports would have been 56 percent greater, all else being equal.



Figure 2  
**Shares of total goods exports among SMEs and large enterprises, by industry, Canada, 2014**



Source: Authors' calculations using Statistics Canada's Trade by Enterprise Characteristics Program, 2014 provisional estimates.

Note: The "other" category includes agriculture, fishing and forestry, finance and insurance, retail trade, information and culture, transportation and warehousing, utilities and construction.

### Export markets served

Given the large fixed costs of exporting, it is not surprising that small firms tend to reach fewer export markets than do large firms: in 2014, most served only one, while most large exporters served multiple markets.<sup>9</sup> Also, the export revenues of large firms are much more concentrated among those that are active in many markets: those that exported to twenty or more countries in 2014 accounted for nearly half of the export values of large firms, compared with only 17 percent for SMEs (figure 3). For this reason, SME trade may be viewed as "more inclusive" than trade by large firms, as the outcomes are more widely dispersed.

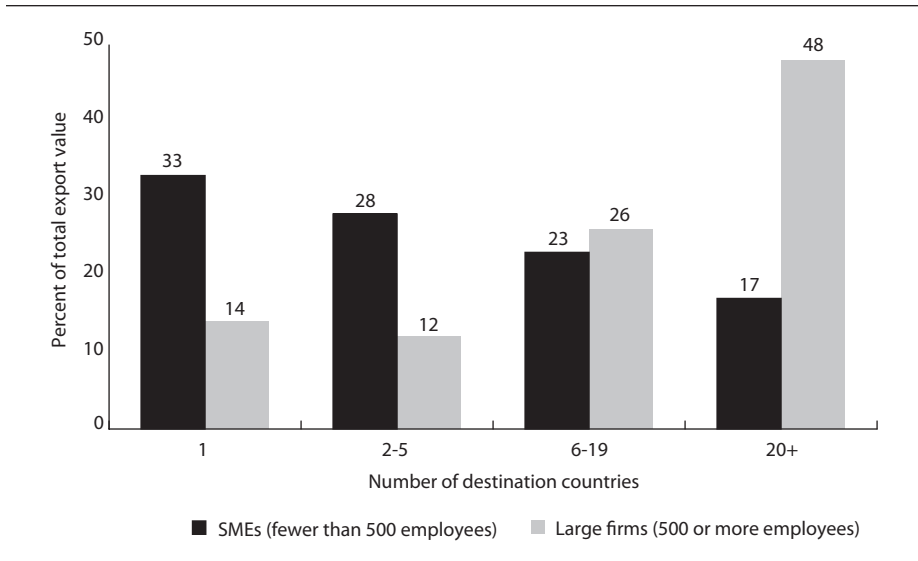
### Export destinations

Focusing now on the actual destinations of Canada's good exports, we first distinguish between the traditionally dominant United States and all other destinations. Consistent with the number of countries SMEs and large firms serve, it is no surprise that SMEs are more singularly focused on the US market than are large firms; as figure 4 shows, more than half exported solely to that market.



Figure 3

**Share of total value of goods exports among SMEs and large enterprises, by number of destination countries, Canada, 2014**

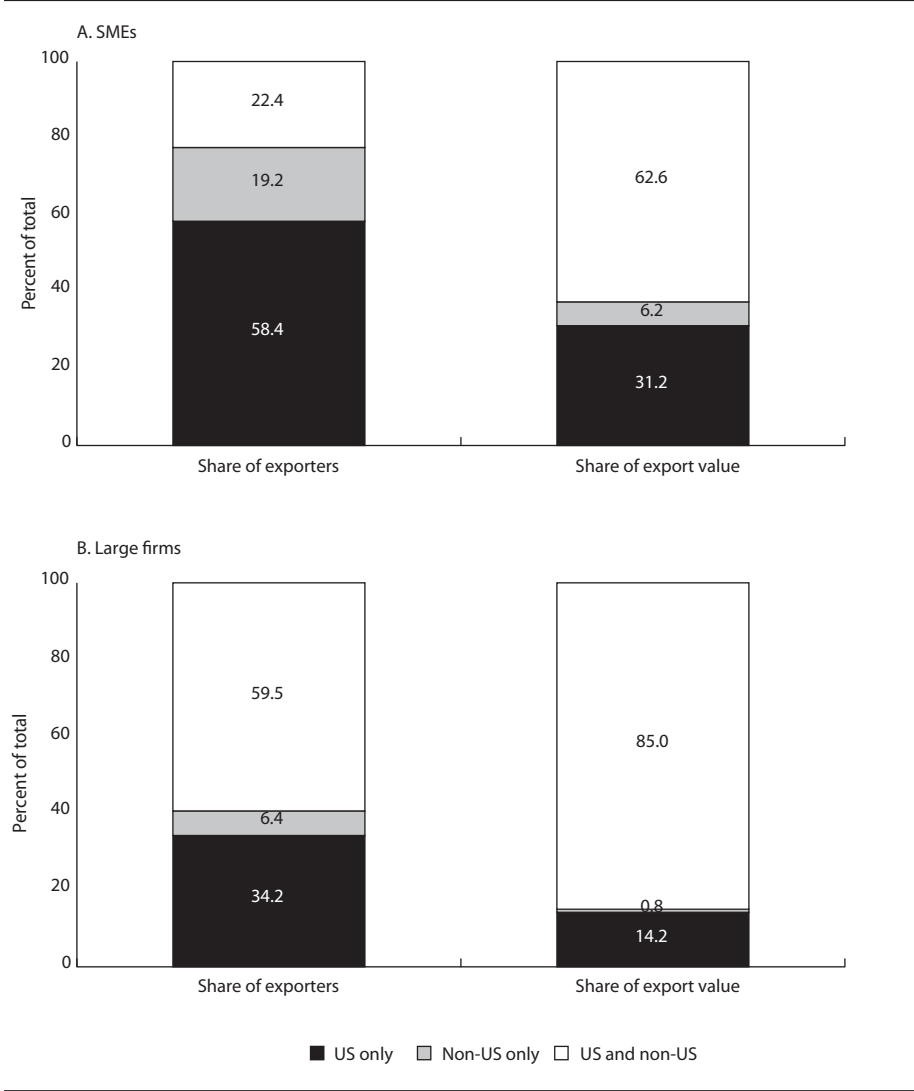


Source: Authors' calculations using Statistics Canada's Trade by Enterprise Characteristics Program, 2014 provisional estimates.

Again, however, firms that exported to multiple market types were responsible for most of the overall export values — 63 percent for SMEs and 85 percent for large firms.

SMEs' shares of total Canadian export values were generally highest in more distant emerging markets in Oceania, Latin America, Africa, Asia and the Middle East, and lower in closer advanced economies in North America and Europe (see table 1 and figure 5). These results might seem counter-intuitive: does this not suggest that smaller firms are more successful than large firms at reaching more distant markets? Not necessarily. Koldyk et al. (in this volume) offer a more likely explanation: many Canadian companies use domestic production facilities to serve closer North American markets via exports, while increasingly serving more distant overseas and emerging markets via outward foreign direct investment (FDI) and foreign affiliates. Although Canadian foreign investment data are not reported by firm size to confirm this hypothesis, it stands to reason that large firms are much more

Figure 4  
**Shares of exporters and total value of goods exported by SMEs and large enterprises to US, non-US and both destinations, Canada, 2014**



Source: Authors' calculations using Statistics Canada's Trade by Enterprise Characteristics Program, 2014 provisional estimates.

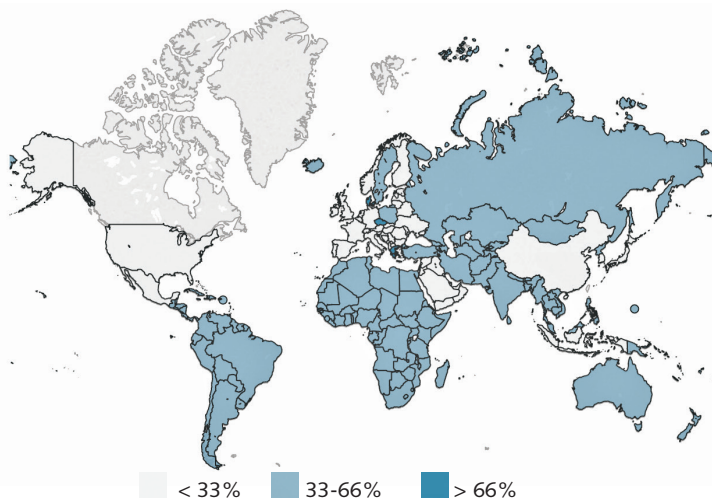
Table 1

**Share of total value of goods exports by SMEs, by region, Canada, 2014**

	SME share of value of goods exports (%)
Oceania	44.8
Central and South America and Caribbean	38.8
Africa	37.2
Asia	31.4
Middle East	29.9
North America	25.2
Europe	17.0
<b>World</b>	<b>25.6</b>

Source: Authors' calculations using Statistics Canada's Trade by Enterprise Characteristics Program, 2014 provisional estimates.

Figure 5

**Share of total value of goods exports by SMEs, by destination, Canada, 2014**

Source: Author's calculations using Statistics Canada's Trade by Enterprise Characteristics Program, 2014 provisional estimates.

Note: National boundaries omitted where only region-level data is available.

likely than SMEs to undertake FDI (due to the large start-up costs involved) and to use foreign affiliates (which are often part of larger multinational enterprises). That is, large firms' export shares are generally lower in emerging markets likely because these firms are more able than small firms to serve those markets through direct investment and foreign affiliates, rather than through exports.

### **Canadian SMEs' Exports, according to Survey Data**

INDUSTRY CANADA'S SURVEY ON FINANCING AND GROWTH OF SMALL AND MEDIUM Enterprises is less precise on export values than Statistics Canada's transactions data. It nevertheless provides a useful complementary perspective by narrowing in on SMEs' overall exporting activities, both goods and services. In 2011, 10 percent of SMEs exported a good or service, but export sales accounted for only about 4 percent of their revenues (Industry Canada 2015); see figure 6.

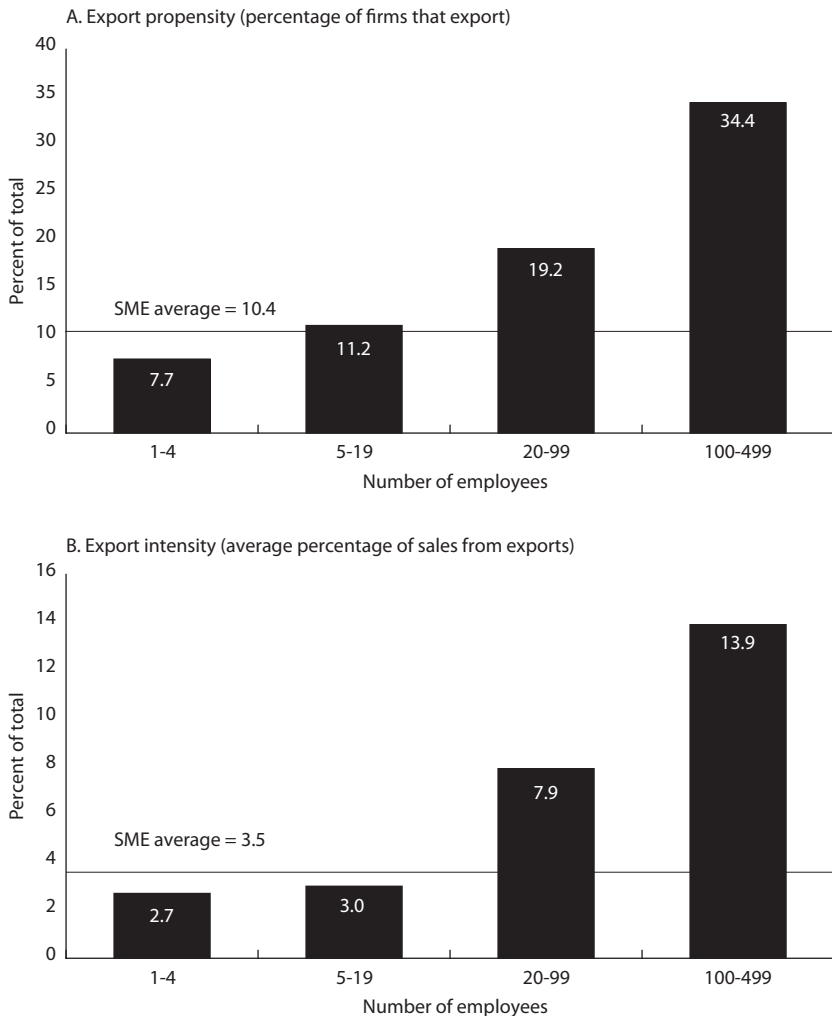
#### **SMEs' exporting activity by firm size among Canadian SMEs**

Even among SMEs, size clearly matters for trade outcomes, as smaller firms trade less than larger firms. Both export propensity (the percentage of businesses that sell goods and/or services abroad) and export intensity (the percentage of total business revenues that comes from exports) increase with firm size, and in 2011 were much higher for medium-sized firms (100-499 employees) than for small businesses (fewer than 100 employees). Industry Canada (2015) attributes these findings to two factors: first, foreign sales can be a source of new growth for larger SMEs when their products are at older and generally slower growth phases of their life cycles; and, second, larger SMEs typically have more capacity to export, including the requisite financial and human resources.

#### **The composition of SMEs' exports**

According to the Industry Canada (2015) survey, among all exporting SMEs in 2011, 49 percent exported only goods, 39 percent exported only services and 12 percent exported both. Results by firm size are consistent with the existence of larger economies of scale in goods production than in services. In other words, it is generally easier for small services producers than small goods producers to compete in world markets because goods production

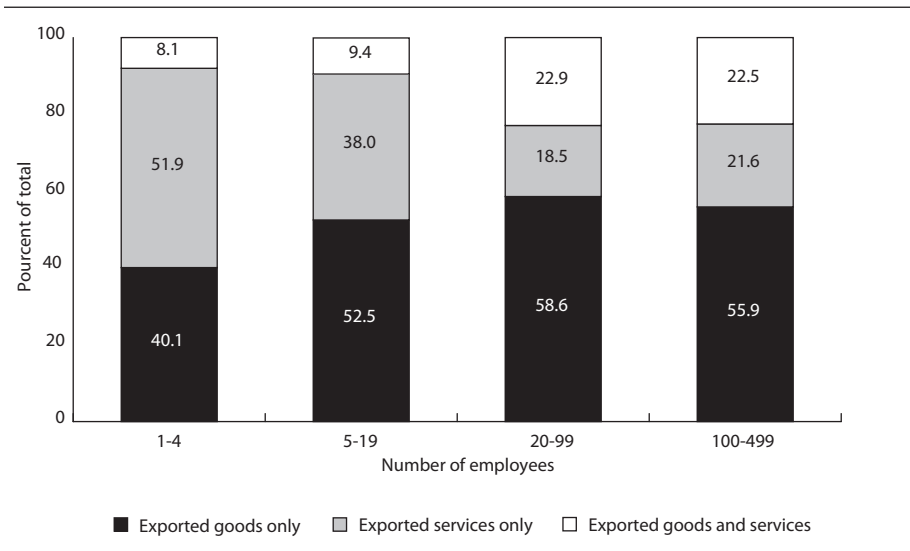
Figure 6  
Export propensity and intensity of SMEs, by firm size, Canada, 2011



Source: Industry Canada (2011).

generally requires higher fixed costs to enter. Indeed, exporting goods was more common for larger SMEs, whereas exporting services was more common for smaller firms. Among exporters, “micro” SMEs (those with fewer than five employees) were more likely to export only services (figure 7).

Figure 7

**Exporting activities of SMEs, by firm size, Canada, 2011**

Source: Industry Canada (2011).

**The sectoral composition of SMEs' exports**

Manufacturing is a key exporting industry for SMEs, but the Industry Canada survey reveals that services-intensive knowledge-based sectors, including information and communications technologies and business consulting, also feature prominently.<sup>10</sup> Other important export sectors for SMEs are wholesale trade, transportation and warehousing, professional services and agriculture (figure 8).

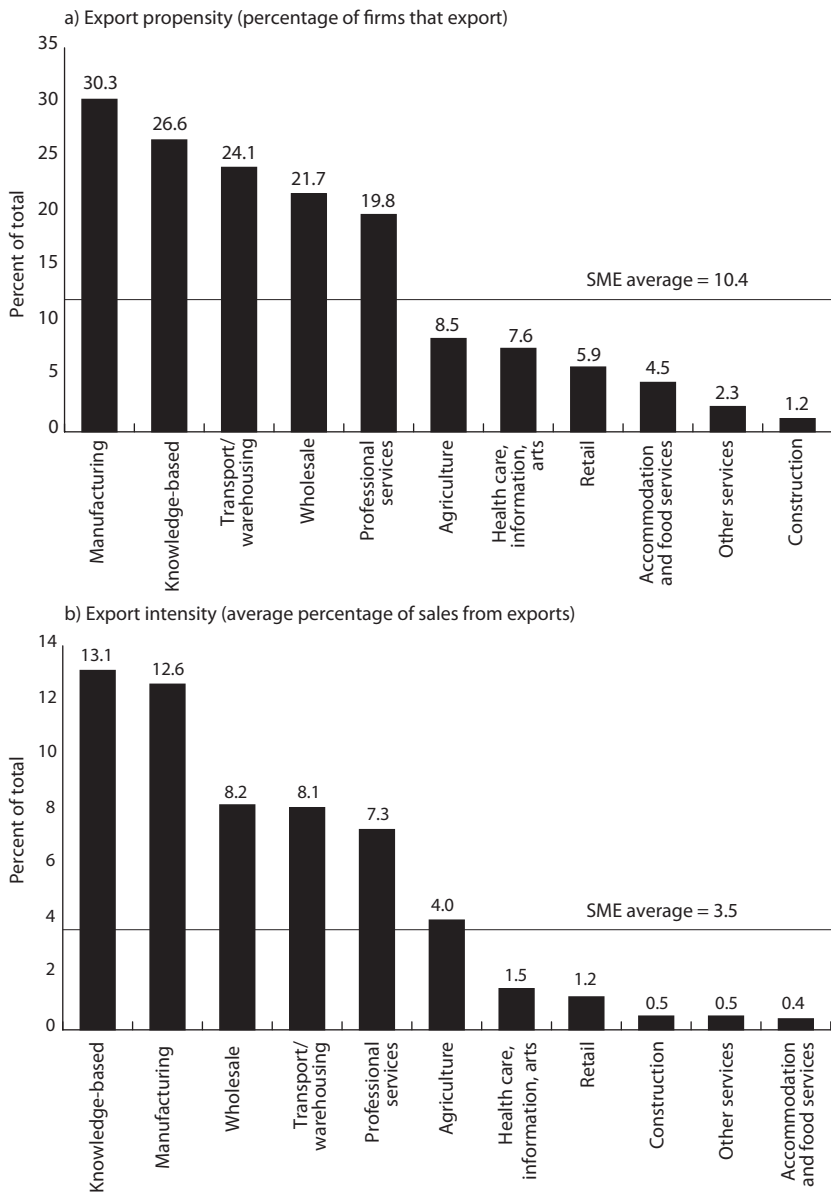
**Exports by firm age**

During their first few start-up years, the vast majority of firms focus primarily on domestic sales. Older, more established firms are more likely to export (figure 9). About 7 percent of the youngest SMEs (two years old and younger) — which includes some of the born global firms — exported a good or service in 2011.

**Export destinations**

As with the transactions data, the survey data from Industry Canada reveal that exports of goods and services by SMEs are highly concentrated in the US market: 89 percent of SME exporters sold there in 2011, representing almost three-quarters

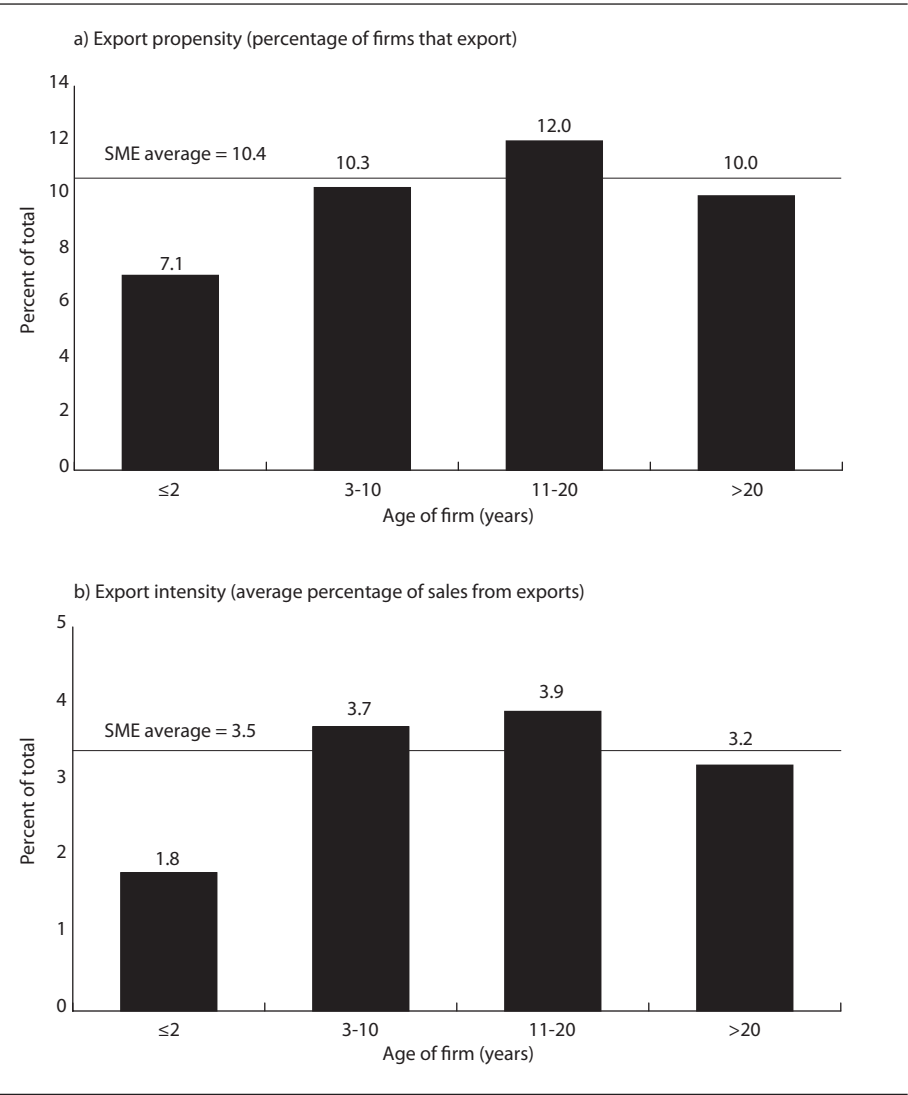
Figure 8  
Export propensity and intensity of SMEs, industry, Canada, 2011



Source: Industry Canada (2011).

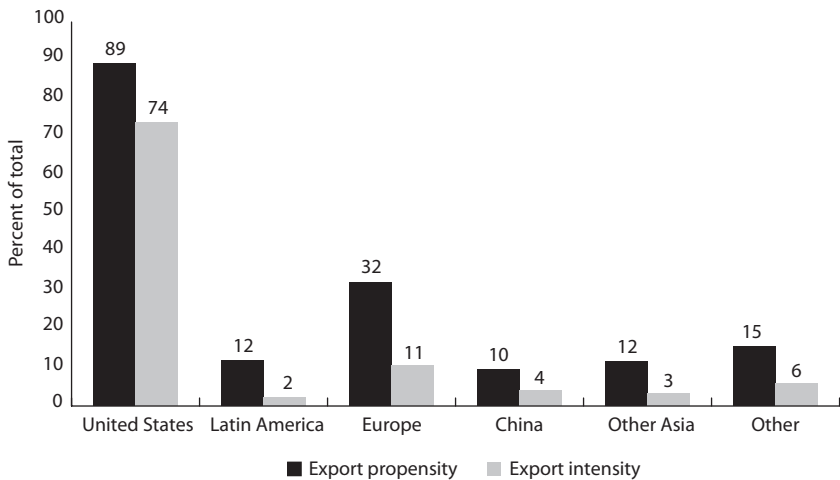


Figure 9  
**Export propensity and intensity of SMEs, by age of firm, Canada, 2011**



Source: Industry Canada (2011).

Figure 10

**Export propensity and intensity of SMEs, by destination, Canada, 2011**

Source: Industry Canada (2011).

of all export revenues (figure 10). Europe was the second most frequent destination, while around 10 percent of SME exporters sold to what might be considered emerging markets. Within Canada, SMEs trade patterns vary by geography and market proximity. Not surprisingly, firms in British Columbia were more likely to export to Asia, firms in central Canada to the United States and those in Atlantic Canada to Europe. Thus, the export baskets of SMEs in the coastal provinces are more market diversified than those in central Canada (Industry Canada 2015).

### Performance premiums

Many researchers have documented that exporters outperform nonexporters according to several measures (see, for example, Baldwin and Yan on trade and productivity, in this volume). As table 2 shows, this general result also holds for Canadian SMEs: in 2011, exporters had higher revenues and profits and invested more in research and development, machinery and equipment, and training. They were also more innovative and more involved in other international activities, such as importing, outsourcing and global value chains. As well, the owners of exporting SMEs were more likely to be born outside Canada and to have higher levels of formal education than Canadian-born owners.

Table 2

**Characteristics of SME exporters and nonexporters, Canada, 2011**

	<b>Exporters</b>	<b>Non-exporters</b>	<b>Exporter premium (% difference between exporters and non-exporters)</b>
Revenue (\$ millions)	3.5	1.6	121
Pre-tax profits (%)	13	11	18
<i>Firms that invested in (%)</i>			
Research and development	24	7	222
New information and communications technology	60	41	46
New machinery and equipment	42	40	5
Training	46	35	33
<i>Percentage of firms that innovated</i>			
Product	40	21	90
Process	26	13	100
Organizational	27	14	93
Marketing	28	15	87
Imported	49	23	113
Outsourced	13	2	529
Were part of a global value chain <sup>1</sup>	13	4	212
Engaged in foreign direct investment	2	1	157
Owner born outside Canada	27	21	26
Owner has university degree	54	32	66

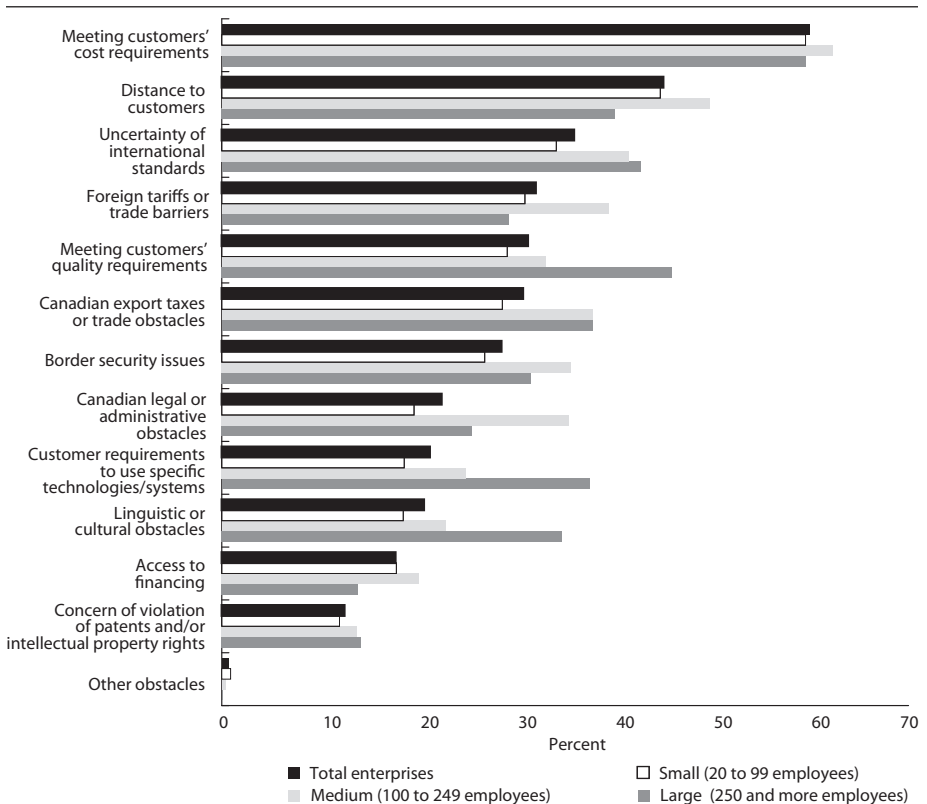
Source: Industry Canada (2011).

<sup>1</sup> Sold goods to a business that used them as an intermediate input in the production of other goods that were then exported.**Perceived barriers to exporting**

Another Industry Canada survey, the 2012 Survey of Innovation and Business Strategies, provides evidence of what firms perceive to be obstacles to exporting. Some of these factors (for example, tariffs) are more amenable to policy intervention than others, such as geography, which is more of a given — notwithstanding how emerging technologies are reducing the importance of distance for trade; see Ahmed and Melin, in this volume. At the top of the list of obstacles, was meeting customers' cost requirements, which 60 percent of firms that exported, or attempted to do so, over the 2010-12 period deemed to be of high or medium importance (figure 11).

Figure 11

**Canadian firms' perceived obstacles to exporting, by firm size, 2010-12 (percentage responding that factor had high or medium importance)**



Source: Authors' calculations based on Statistics Canada, CANSIM database, table 358-0225.

Other often-cited obstacles were distance to customers; uncertainty of international standards; tariffs and trade barriers; meeting customers' quality requirements; and Canadian export taxes or trade obstacles. Only 21 percent of respondents cited linguistic or cultural barriers as of high or medium importance — despite the emphasis on such obstacles in the international business literature. Moreover, these barriers were much less of a concern for SMEs than for large firms; as we will see later, language is an area of relative strength for SME exporters owned by recent immigrants to Canada. Access to financing was even farther down the list (cited by 18 percent), but was slightly more of a concern for smaller firms. It is noteworthy

that, for most obstacles, the responses of small firms did not differ much from those of large firms — defined in this survey as those with 250 or more employees.

## **Canadian SMEs' Exports, according to Longitudinal Data**

**I**N CONTRAST TO THE TRANSACTIONS AND SURVEY DATA, WHICH PROVIDE INFORMATION ON exporting activities in a largely descriptive and static manner — that is, without attempting to control for other factors that affect outcomes, and viewed only at a recent point in time — longitudinal data have the advantage of tracking firms over time.

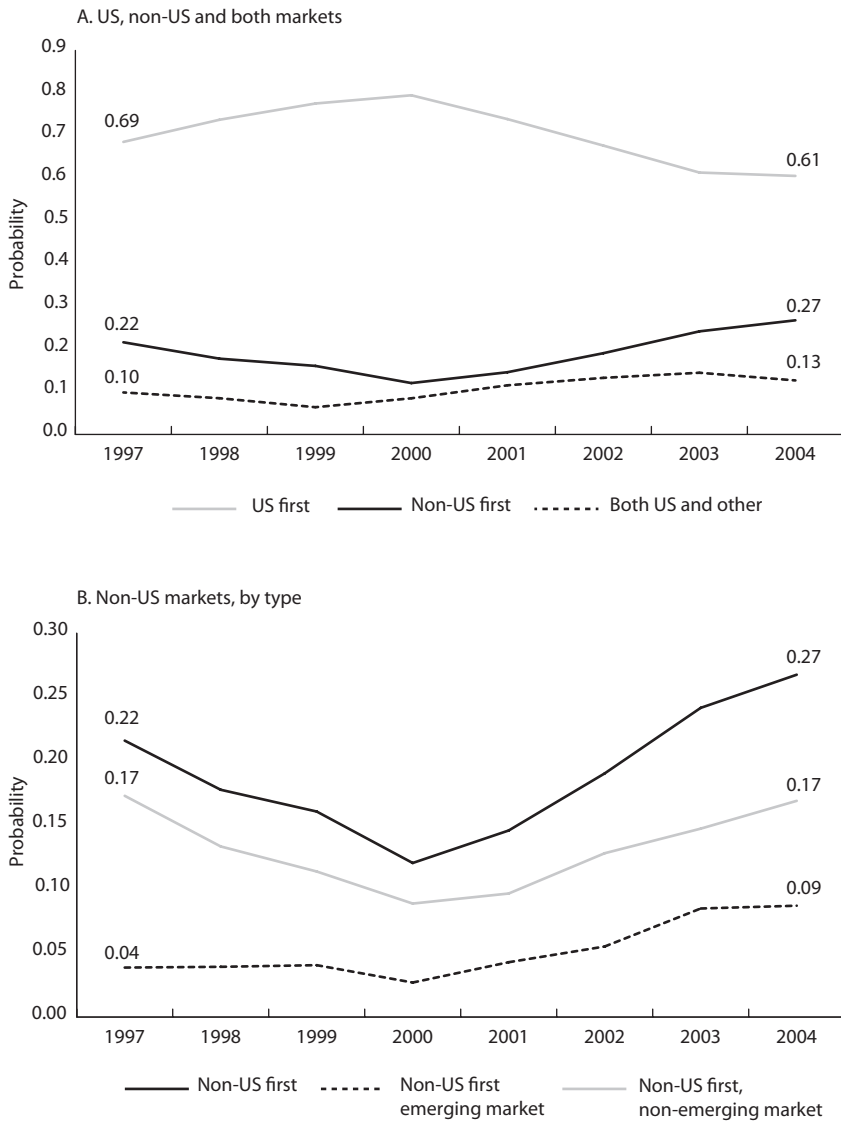
### **Diversification of export entry patterns**

Sui and Yu (2012) find that a distinct shift occurred in the foreign market expansion patterns of Canadian SMEs around 2000.<sup>11</sup> On average, over the period between 1997 and 2005, most SME exporters (69 percent) chose the United States as their first export destination (figure 12). This share initially rose from 1997 to 2000, coincident with strong economic growth in the United States and weakness in some emerging markets related to the 1997 Asian economic crisis. After 2000, however, the probability that a new Canadian exporter chose the United States first fell quickly, concurrent with a thickening of the Canadian-US border after the 9/11 terrorist attacks (Burt 2009; Ferris 2010; Globerman and Storer 2009). The “US-first” firms were generally younger, less productive and more likely to be Canadian-controlled, and they exported fewer product varieties.

Meanwhile, a smaller but growing share of SME exporters chose less-traditional export market pathways. On average, between 1997 and 2005, 17 percent of SME exporters chose a market other than the United States (on its own) for their initial destination, with the share rising significantly after 2000, reaching over one-quarter in 2004. These firms were generally the smallest exporters, more likely to operate through a single establishment and to be non-US foreign-controlled.

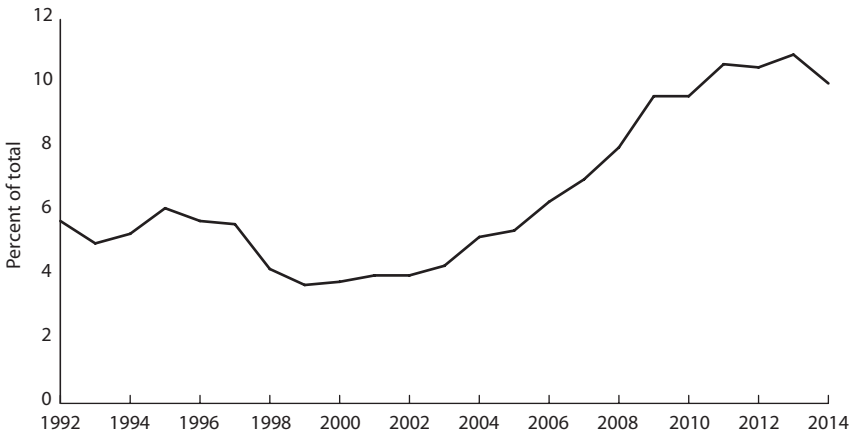
There was also a slight increase in the proportion of firms that started exporting to both the US and other markets at the same time, rising to 13 percent. These firms were generally the largest and most productive, and were also the most likely to be US-controlled and to have multiple establishments and more diversified products. There was also a clear increase over this period in the share of SME exporters that chose emerging markets as their first export destination.

Figure 12

**Average Canadian exporters' probability of choosing different initial market destinations, 1997-2004**

Source: Adapted from Sui and Yu (2012, figure 1).

Figure 13

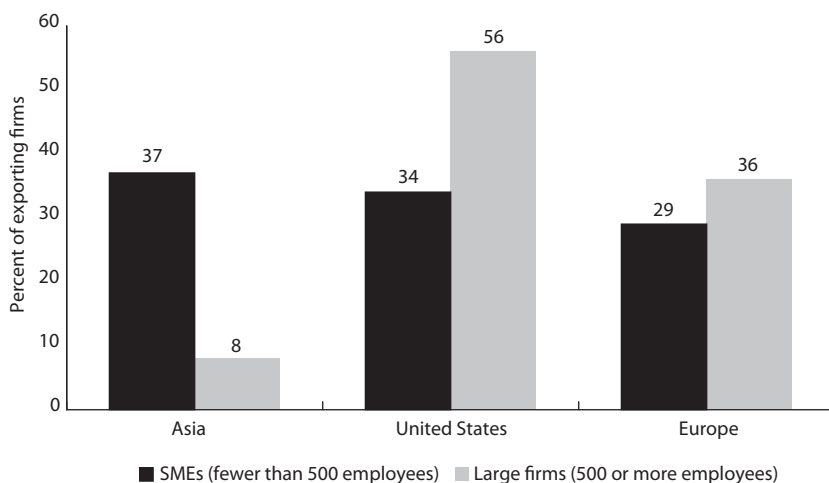
**Emerging markets' share of total value of exports, Canada, 1992-2014**

Source: Authors' calculations using Innovation, Science and Economic Development's Trade data online.

Consistent with the firm-level economic theory, an analysis of the pathways Canadian exporters take to break into emerging markets (Sui and Yu 2013)<sup>12</sup> finds that those that did so successfully were the most efficient producers — that is, they had the highest labour productivity and lowest unit labour costs.<sup>13</sup> They were also more likely to be foreign-owned. Unfortunately, the detailed firm-level data used in that analysis are not yet available for the period after the global recession that began in 2008. In lieu of that data, we constructed results based on aggregate trade data to investigate whether the general trend of increased Canadian exports to emerging markets has continued — at least overall, if not necessarily for new Canadian exporters or SME exporters. Using the categorization of emerging market “priority countries” identified in the Harper government’s Global Markets Action Plan,<sup>14</sup> we find that the overall share of Canadian exports going to emerging markets rose from 4 percent in 2000 to over 10 percent in 2014 (figure 13) — results that are consistent with those of the earlier firm survey presented in figure 10. The upward trend over this period is also consistent with the generally stronger economic growth in emerging markets, such as China, and the slow recovery in advanced economies after the global financial crisis, particularly in Europe. These results suggest that the trend of Canadian firms increasingly choosing emerging



Figure 14

**Destination of first export market, firms in digital economy sector, Canada, 2016**

Source: Horton (2016).

Note: Based on 129 Canadian firms in the Creating Digital Opportunity dataset for the CanAsia map.

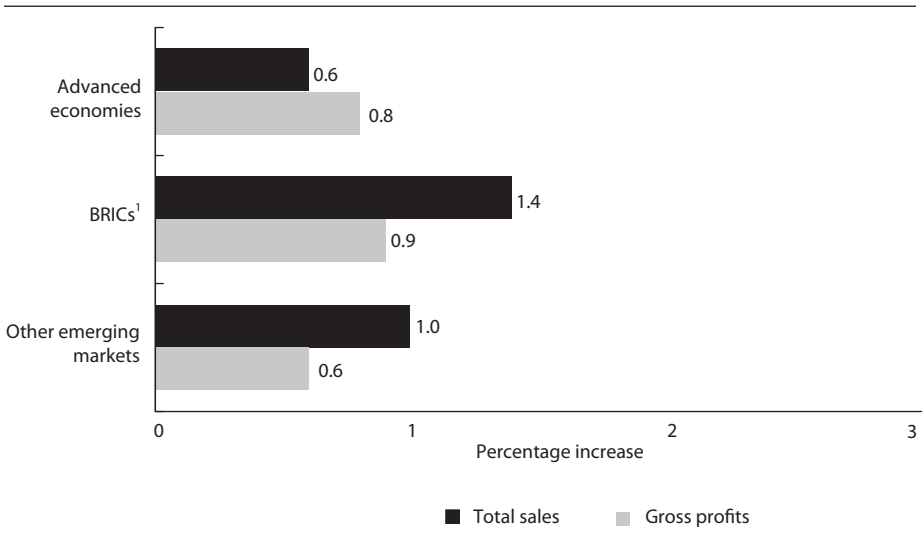
markets as their initial export destination likely has continued since the global recession.

Further suggestive evidence comes from an interesting new data source being developed at the University of Toronto's Munk School of Global Affairs. This source — the CanAsia mapping project, which maps the locations of Canadian businesses operating in Asia — shows that the export patterns of SMEs are becoming increasingly geographically diverse. Preliminary analysis focusing on firms in the professional and technical services sector, including software companies, finds that SMEs are actually more likely to export first to Asia than to the traditional US export market. By contrast, large digital economy firms remain more likely to export first to the United States, followed by Europe and then Asia (figure 14).

### **SMEs' performance premiums and gaps in emerging markets**

Given the policy focus on getting more Canadian SMEs to export to emerging markets, it is important to know if systematically larger performance benefits are associated with exporting to these markets. To that end, Sui and Goldfarb (2014) investigate the effects of exporting to different market types on the performance of

**Figure 15**  
**Increase in sales and profits associated with a 10 percent increase in SMEs' exports, by destination market, Canada, 1994-2008**



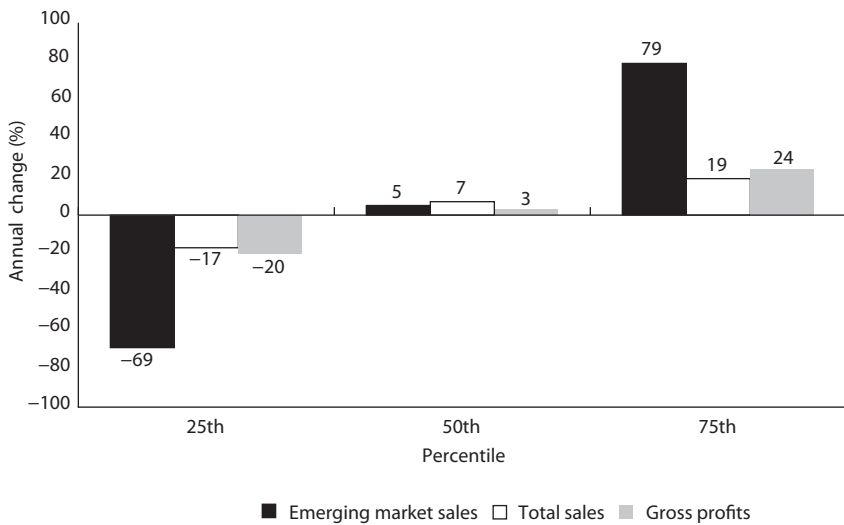
Source: Sui and Goldfarb (2014, appendix B, tables 1, 2).

<sup>1</sup> Brazil, Russia, India and China.

Canadian SMEs over the period from 1994 to 2008, grouped by those that export to advanced markets (the United States, the European Union and Japan); the BRICs markets (Brazil, Russia, India and China); and other emerging markets. Controlling for other factors, the authors find that exporting is indeed associated with higher sales and profits for Canadian SMEs. And while this holds for all of the export destination groups considered, slightly larger gains came from exporting to the BRICs economies,<sup>15</sup> where a 10 percent increase in exports increased SMEs' total sales and gross profits by 1.4 percent and 0.9 percent, respectively (figure 15).

These results suggest that efforts to raise Canadian SMEs' exports to emerging markets might actually provide a slightly better performance boost than increasing their exports to other destinations — at least on average. But what if emerging markets are riskier? To investigate how closely these results were clustered around the average, the authors examine various performance measures — including the growth of sales and profits and the number of consecutive years operating in the export market — for SMEs that exported between 1994 and 2008, focusing on top performers (those ranked at the 75th percentile of the

Figure 16

**Export performance by SMEs, by percentile, Canada, 1994-2008**

Source: Sui and Goldfarb (2014).

relevant distribution), median performers (at the 50th percentile) and bottom performers (at the 25th percentile), not controlling for firm characteristics.

As figure 16 shows, the median Canadian exporter enjoyed decent performance, but there were huge performance gaps between the top and bottom exporters, particularly in emerging markets. As expected, the top exporters performed quite well: their sales grew by 19 percent and their total profits by 24 percent annually; emerging market sales grew much faster, by 79 percent per year. Bottom-performing exporters, however, had far worse outcomes, with their profits and sales falling by similar amounts to the gains of top performers. This result implies that, in attempting to achieve the slightly bigger rewards in emerging markets, Canadian exporters incur significantly higher risks.

### **Export strategies, firm capabilities and market survival**

How do export strategies, together with firms' characteristics, affect the survival of Canadian SMEs in export markets? As Sui and Baum (2014) document, most Canadian exporters (69 percent in their sample) used a "gradual internationalizer" approach, while 25 percent were "born regional"; only a very small proportion

(6 percent) were truly born global.<sup>16</sup> Born global firms had the highest probability of exit from exporting, followed by those born regional, suggesting that born global firms incur more risk. However, once the authors control for different types of firms generally having chosen different strategies, no particular export strategy seemed to be strictly superior. Sui and Baum conclude that no easy, generic guidance can be offered on which strategy firms should pursue, as it depends on their circumstances. The authors do find, however, that being larger, more innovative and more productive is associated with better export survival, particularly for Canadian exporters operating in non-US markets.

Sui and Goldfarb's (2014) results highlight the importance of prior experience as well as on-going innovation for export survival. Specifically, they find that Canadian SME exporters generally had a better chance of surviving in emerging markets if they were older when they entered (that is, if they had spent more time operating in the domestic market before exporting), had exported to an advanced economy first (consistent with the gradual exporting approach), were larger (had more employees), paid higher average wages (an indicator of a more productive firm with higher-skilled employees), were more innovative (that is, if they introduced new products more often into emerging markets), had more access to external financing (leverage) and exported to more destinations (table 3).

### **The role of recent immigrants in reaching beyond the US market**

Recent immigrants possess many vital skills that might help Canadian exporters tap into nontraditional markets, including language skills, social networks and knowledge of local cultural and business practices.<sup>17</sup> Sui and Morgan (2014) find that SMEs whose majority owner is a recent immigrant were more than twice as likely as other firms to export to non-US markets. The authors note that this is a rather small group to draw from, representing only about 3 percent of all Canadian SMEs. Moreover, SME exporters owned by recent immigrants were generally less profitable than other exporters, perhaps relating to the industrial composition of the former's exports: recent-immigrant-owned-exporters are more active in sectors such as wholesale and retail trade, which, as we have seen, tend to generate less export revenue on average.

Building on the finding that sharing a common language often promotes trade relationships (see, for example, Anderson and van Wincoop 2004), Sui, Morgan and Baum (2015) confirm that language influences firms' internationalization strategies. After controlling for other factors, SMEs owned by recent

Table 3

**Estimated effect of firm characteristics on the probability of exit by SMEs from emerging markets, Canada**

<b>Firm characteristic</b>	<b>Estimated coefficient</b>	<b>Standard error</b>
Age at internationalization	-0.061***	0.008
Advanced market first	-0.487***	0.104
Number of employees	-0.010***	0.003
Average wage	-0.007***	0.001
Product innovations	-0.012***	0.002
Leverage	-0.098***	0.016
Number of export destinations	-0.008***	0.002
Re-enter	0.126***	0.036

Source: Sui and Goldfarb (2014, appendix B, table 5).

Leverage = company equity as a share of assets.

\*\*\*  $p < .01$

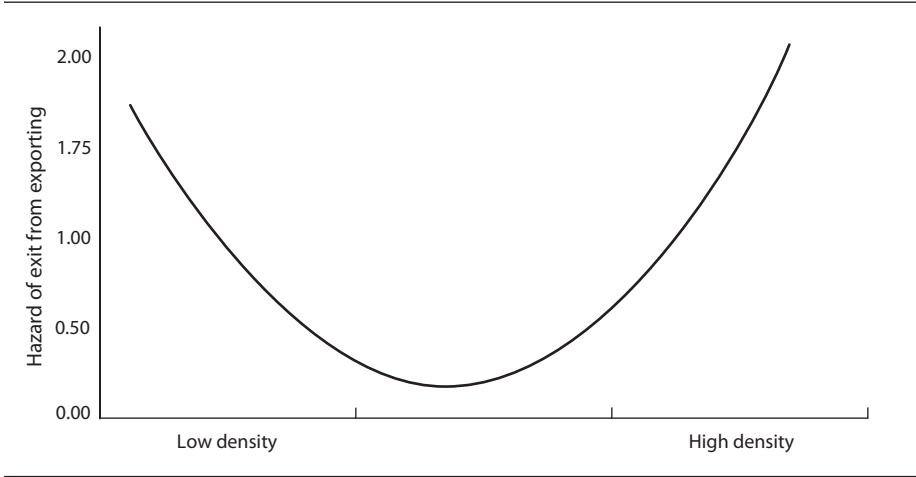
immigrants were more likely to export to non-US markets, particularly when the owners' mother tongue was not English.

### **The presence of other Canadian exporters**

Recent research by Sui, Baum and Malhotra (2015) complements the findings that specific firm characteristics influence internationalization strategies. The authors examine so-called home-peer entry density — that is, whether the number of other domestic firms in the same industry that export to the same foreign market when the firm starts exporting there — affects firms' survival in that market. Consider the case of Canadian firms trying to export ice wine to China. This attempt might be particularly risky for the first few firms that try to break into the market with little brand awareness. At first, the entry of other Canadian ice wines might help the chances of survival of similar Canadian brands. If too many enter, however, the Chinese market eventually might become crowded with Canadian ice wines, and this tougher competition for market share might make it harder to distinguish among specific products, and thus for their makers to survive in the new market. Indeed, Sui, Baum and Malhotra (2015) find a U-shaped relationship between the probability that a Canadian SME will leave an export market and home-peer entry density, controlling for firms' characteristics and competition from all other countries.

Figure 17

**Effect of home-peer entry density on the hazard of exiting from exporting**



Source: Baum, Malhotra and Sui (2015).

This work highlights two competing effects from the entry of new firms into the foreign market. For the first few firms to enter, the likelihood of exit is high. Initially, as other firms enter (moving to the right in figure 17), this might help “grant legitimacy” and build awareness of the Canadian brand in the new market, which lowers the likelihood that Canadian firms will leave the market. At a certain point, however — when sufficient numbers have entered to establish awareness of the Canadian brand — a “competition effect” takes over, and more firms entering increases the chances of leaving. Interestingly, Sui, Baum and Malhotra (2015) find that the firm’s age at entry affects the strength of peer-firm effects, and that younger Canadian SME exporters are more responsive. On the plus side, the younger firms benefit more by being among the first to introduce their products, but they are also hurt more by the increased competition of additional firms.

**The effectiveness of government support programs**

Unfortunately for policy-makers, there is little direct evidence to guide the role that Canadian government policy should play to encourage exports. Van Biese-broeck, Yu and Chen (2015) is one important recent contribution that examines the effectiveness of Canada’s Trade Commissioner Services (TCS), which include “information provision” — for instance, on market prospects, local companies,

key contacts and face-to-face briefings — and “troubleshooting” services — such as solving problems with customs clearance or unfair business treatment. Interestingly, only about 5 percent of Canadian exporters use TCS, and these clients have certain characteristics. Relative to exporters who do not use TCS, these firms tend to export more and to export multiple products to multiple destinations beyond the United States, and their export performance often deteriorates before they seek government help.

In a careful econometric analysis, the authors find that the Trade Commissioner Services were effective in increasing exports for client firms, with a positive, one-time boost of about 10 percent in export values. It is important to note that this study does not evaluate whether the services helped firms become first-time exporters. Rather, it examines the impact of these services for *existing* exporters, and finds that the services helped existing exporters to raise sales of products they were already selling in destination markets that they already served (the so-called intensive margin of trade), and that trouble-shooting was more effective than information provision services. (It is likely the case that, for first-time exporters, the information provision role would be more important.) The positive effects of TCS were larger for older, more experienced firms. Moreover, the duration of government support also influenced its effectiveness, as exports increased more for firms that received sustained support over several years.<sup>18</sup>

## Discussion and Conclusions

ON AN ENCOURAGING NOTE, CANADIAN EXPORTS HAVE REACHED INCREASINGLY diversified markets over the past decade and a half, with the share of total exports destined for emerging markets rising from around 4 percent in 2001 to around 10 percent in 2014. Moreover, SMEs increasingly have chosen emerging markets as their first export destination. Despite these shifting trade patterns, however, the United States remains Canada’s largest export market by a wide margin.

SME trade differs systematically from the trade of large firms in several ways. Although there are many more SMEs than large firms exporting, they are far less likely to export than large firms, their average export revenues are much lower, they reach fewer markets (often only the United States) and their activities are more concentrated in industries with lower export revenues. The bad news, then, is that SME trade is much less productive, on average, than trade by large



firms. The silver lining is that SME trade is naturally more inclusive, with many more participants and much more dispersed market outcomes — features that help explain the strong political appeal of targeting policy support to SMEs.

Exporting has long been associated with better firm performance, and Canadian SMEs that exported to emerging markets performed slightly better on average than those that exported to other destinations. Unfortunately, in seeking the larger rewards in these markets, Canadian firms may incur higher risks and higher entry costs.

Are there ways to improve the chances of success in these markets? The evidence shows that Canadian SME exporters generally have better chances of surviving in emerging markets if they are older when they enter, export to an advanced economy first, are larger, are more productive, introduce new products more often, have better access to external financing and export to more destinations. Clearly, there is scope to encourage and assist high-potential SMEs with these particular characteristics in their efforts to expand into emerging markets — and to help firms acquire these characteristics. Less experienced or less competitive SMEs should not be pushed into emerging markets too soon. Often, a gradual export strategy is more appropriate, focusing first on the local or regional market, while building up capabilities, resources and knowledge before trying to expand into riskier emerging markets, if at all.

At the same time, an alternative path is being followed by a small, but growing proportion of Canadian firms that are “born global,” serving emerging markets in their first few years of operations. There is also preliminary evidence of the emergence of smaller, services-based firms in the high-tech sector that are making progress exporting into Asian markets. This is consistent with the findings of Ahmed and Melin (in this volume) that technology-enabled small businesses export into far more markets than do traditional exporters.

Some government policies appear to have played a supportive role in increasing Canadian exports — at least for existing exporters, though their effectiveness in helping first-time exporters is still unknown. Those designing government support programs could benefit from having additional robust empirical evidence on what support works best (not only for the Trade Commissioner Services, but also for other programs),<sup>19</sup> for which types of Canadian firms and in which markets.

It seems clear that government has important roles to play as both “trouble shooter” to help address problems for existing exporters and as “information

provider” to survey market conditions. In so doing, it could help potential entrants reduce their risks and learn more, and more quickly, about their chances of success in a given market. In fact, without government intervention, the private sector will generally collect insufficient market information because of the “free rider” problem, whereby firms are reluctant to collect information themselves due to worries that their potential competitors could “free ride” on their initiative by soon after exporting similar products to the same market.<sup>20</sup>

Government information should be tailored to the needs of firms, particularly those that are younger and smaller, that generally need more external assistance and that also might be more receptive to implementing the information and process changes needed to succeed in emerging markets. Given the surprisingly low take-up of government supports in Canada among exporters (only about 5 percent), policy-makers should continue their efforts to increase awareness of existing programs and design them better to the needs of SMEs (as Mallett, in this volume, suggests). “Go Global” workshops for SMEs introduced in 2014 are an example of efforts to increase the visibility and use of government programs; although firms likely cannot explore all of the relevant information in a single session, these interactions can be a useful start to the learning process.<sup>21</sup>

Another important and complementary role for government, as suggested by the firm-level trade literature, is to lower the costs for Canadian firms to enter emerging markets. This could be done, for instance, by negotiating free trade agreements with these countries, which would directly lower tariffs and generally improve market access. Here, the recently concluded Trans-Pacific Partnership (TPP) could play a supportive role;<sup>22</sup> bilateral negotiations with the largest emerging markets (China and India) could also help — on China, see Wolfe, in this volume, and Dobson and Evans (2015); on India, see Rao and Tapp (2015).

Much like trade deals, foreign investment agreements could also offer similar benefits. Most Canadian export revenues come from firms that export to multiple destinations at the same time. These firms tend to be the largest and most productive and to have multiple establishments and more diversified products. They are also more likely to be foreign-controlled, which suggests that complementarities might well exist between increasing inward FDI in Canada and boosting Canadian exports abroad.

Applying additional policy scrutiny and questioning conventional wisdom can often be a good thing. Some strategies might sound good in theory, but further

empirical investigation could reveal important limitations. For instance, most analysts would support the idea of leveraging the skills of recent immigrants from emerging markets, since this group is already more likely to export to these markets and to have the necessary language skills and social networks. Unfortunately, there are limits to this approach because these entrepreneurs are relatively few in number and their firms tend to be less productive than other Canadian exporters on average.

Finally, trade policy discussions in Canada should not simply focus narrowly on how to increase SME exports to emerging markets, but take a broader view. This approach could start by acknowledging that exporting directly to emerging markets is not the only way for SMEs to seize the benefits of growth in those markets. Other strategies might provide similar benefits with less risk — for example, helping SMEs build up their resources and capabilities in Canada or in less challenging foreign markets first, with a long-term goal of getting into emerging markets. Canadian SMEs also could participate effectively in global supply chains by selling intermediate goods or services to multinationals based in Canada or the United States that are active in emerging markets. Taking part in international joint ventures, or franchising or licensing arrangements also could be a promising initial way for many firms to gain market entry. Gaining a better knowledge of these types of activities and of the importing behaviour of Canadian SMEs remain promising avenues for future research.

## Appendix A: Describing the Firm-Level Data

In this chapter, and following the definition used by Innovation, Science and Economic Development Canada, SMEs are classified as firms with 500 or fewer employees. Sui and Yu (2012), Sui and Yu (2013), and Sui and Baum (2014) construct a unique longitudinal (1997-2004) dataset by linking Statistics Canada's Exporter Register (1993-2005), Business Register (1993-2005) and Longitudinal Employment Analysis Program (LEAP) (1997-2004). This dataset includes all Canadian exporters that had at least one shipment to a foreign market between 1993 and 2005.

The Exporter Register, the main source, is an authoritative, customs-based database that includes all officially registered Canadian merchandise trade transactions. These data are obtained from the Canada Revenue Agency and US customs documents. The Exporter Register allows one to track the year a firm started exporting, the value of its exports, the products it exported each year and the destinations of those exports. The Business Register includes all active businesses in Canada that have corporate income tax accounts, are employers or have goods and services tax accounts. The Business Register provides annual information on each firm's revenue and ownership (over the 1997-2005 period). The third data source, the LEAP, provides annual information on firms' employment (1997-2004) and includes all firms incorporated in Canada that legally hire employees.

The dataset used in Sui and Goldfarb (2014), Sui and Morgan (2014) and Sui, Baum and Malhotra (2015) was constructed by Statistics Canada's Centre for Data Development and Economic Research by linking the Exporter Register (1993-2008) and T2-LEAP (1993-2008). This dataset includes all incorporated Canadian firms that legally hired employees or filed a corporate income tax return in at least one year between 1993 and 2008, and is the most authoritative and best suited to study the behaviour of SMEs. T2-LEAP was created by merging two administrative databases: (1) the LEAP, which provides information on the firm's employment, wages, industry and location; and (2) the Corporate Tax Statistical Universe File (T2SUF), which provides information on the firm's sales, assets and equity.

It is important to emphasize that all of the above studies exclude firms that were established before 1994 — which therefore excludes some older, more established Canadian exporters — because important variables of interest in these studies, such as the firm's first export destination, its age at internationalization, its initial size and so on, were unavailable for firms established before that date.

## Appendix B: Defining Emerging Markets

Country	Sui and Yu (2013)	Sui and Goldfarb (2014)	Broad Canadian interests	Specific opportunities for Canadian business
Brazil	x	x	x	
Chile	x	x	x	
China	x	x	x	
Colombia	x	x	x	
Czech Republic	x			
Egypt	x	x		
Hong Kong		x	x	
Hungary	x	x		
India	x	x	x	
Indonesia	x	x	x	
Israel		x	x	
Malaysia	x	x	x	
Mexico	x	x	x	
Morocco	x			x
Peru	x	x	x	
Philippines	x		x	
Poland	x	x		
Russia	x	x	x (since removed)	
Saudi Arabia		x	x	
Singapore		x	x	
South Africa	x	x	x	
South Korea	x	x	x	
Taiwan	x	x		
Thailand	x	x	x	
Turkey	x	x	x	
United Arab Emerites		x	x	
Vietnam		x	x	
<b>Total</b>	<b>21</b>	<b>24</b>	<b>20</b>	

Note: This table lists the specific emerging markets that are included in Sui and Yu (2013), Sui and Goldfarb (2014) and DFATD (2013).

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## Notes

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1. The goal, as outlined in the Global Markets Action Plan, was to increase SMEs' contribution to Canadian exports to emerging markets from 29 percent in 2013 to 50 percent by 2018. The government estimated this would raise the number of Canadian SMEs that export to emerging markets from roughly 11,000 to 21,000, and it also gave some general guidance for this policy by identifying 20 emerging market countries that it viewed as having the best potential for broader Canadian commercial interests (Canada 2013).
2. Path-dependence, aided by initial luck, also might help to explain the persistent differences between traders and nontraders. A firm that initially performs better, for whatever reason, will have higher revenue and profits. This will allow it to undertake more costly innovation activities, which, in turn, can further increase its productivity and profits relative to other firms.
3. Examples from the firm-level economics literature include Eaton et al. (2008) and Alborno et al. (2012). Eaton et al. find that gradual internationalization was a popular strategy for Colombian exporters, who often started exporting to a single neighbouring foreign market. The subset of firms that survived in their first export market generally expanded into additional destinations within the region. These regional markets served as additional testing grounds for exporters to learn more regarding their potential for success farther abroad, and the most successful firms continued on to larger markets in member countries of the Organisation for Economic Co-operation and Development. Notably, Eaton et al. also find that the initial choice of market destination influenced exporters' survival probabilities.
4. Similar to the economics literature, this line of research also suggests that exporting provides positive feedback effects that can enhance the operations and brands of firms in their domestic markets, enabling them more effectively to access and mobilize the resources they need to grow abroad.
5. For example, available transactions data cover only goods trade. Firm-level surveys capture exports of both goods and services, but the values from these self-reported results do not necessarily match those reported by the statistical agencies. Longitudinal studies are able to track the performance of the same firms over time, but they typically are limited only to goods exports, are harder for outside researchers to access and are available only with a long reporting lag (see appendix A).
6. One exporting "enterprise" might consist of several plants or entities operating within a larger business organization. Here, an SME is defined as having fewer than 500 employees across all affiliated entities.
7. In 2014, the top 10 goods-exporting enterprises — all large firms — collectively exported almost as much as the 39,950 SME exporters (\$116.2 billion versus \$119.6 billion, respectively). These top 10 exporting enterprises had complex business structures that included 220 different declaring units.
8. According to Statistics Canada, the "business services" category (NAICS classification 55) includes many companies with head offices or holding companies as the main enterprise. Goods exports from these enterprises are attributed to "services" industries.

9. According to Statistics Canada's Trade by Enterprise Characteristics data, in 2014, 71 percent of Canadian SME exporters, but only 36 percent of large exporters, served only one country.
10. Innovation, Science and Economic Development Canada classifies as knowledge-based industries those in science and technology fields and those with high research and development activity. Additional examples include pharmaceuticals and aerospace.
11. This research tries to identify changes in export patterns over time for firms with similar characteristics. The authors estimate an average Canadian exporter's predicted probability of choosing different types of entry patterns, based on the year in which it started exporting, and they use regression techniques to control for the size, productivity, country-of-control, industry, location and other variables. They use year-of-exporting dummy variables to capture time-varying factors, such as changes in political risks, tariffs and exchange rates.
12. A firm is categorized as "emerging first" if it exported to at least one emerging market during the first two years of its exporting activities. Firms can also get into emerging markets after first exporting to a US or non-US market (labelled "US to emerging" and "non-US to emerging," respectively).
13. Sui, Yu and Baum (2013) find that the SME exporters that initially had better performance (higher revenue per employee) were more likely to choose a born global (non-US) over a born regional (US) strategy.
14. See appendix B for the list of countries; results based on alternative definitions of emerging markets are quite similar.
15. These estimates are based on regression analysis that uses a dynamic panel data model. This approach attempts to control for endogeneity due to self-selection in exports and in export strategies (market destinations). In addition, controls are included for firm size, average wages, the number of export destinations, company age and leverage, as well as for industry, province and year dummy variables. For details, see Sui and Goldfarb (2014, appendices A and B).
16. In Sui and Baum (2014), in line with previous studies (such as Knight and Cavusgil 1996), a firm is classified as "born global" if it exported within two years of its inception, had an export intensity of 25 percent or higher and exported to non-US markets during the first year of exporting. A firm is classified as "born regional" if it started exporting within two years of its inception, had an export intensity of 25 percent or higher and exported to the regional market (the United States) only during its first year of exporting. The remaining firms were classified as "gradual internationalizers."
17. Recent immigrants are defined as those who have lived permanently in Canada for less than five years.
18. This result is intuitive, but it is important to keep in mind that it is the firm that ultimately decides whether or not to continue to receive support, so presumably those that chose to continue did so because they felt they were receiving program benefits.
19. For instance, program evaluation evidence for services provided by the Business Development Bank of Canada (which can help with business strategy and financing), Export Development Canada (which has insurance for sales and assets due to credit and political risk, and bank guarantees to free up capital) and Canadian Commercial Corporation (which helps Canadian exporters access other countries' government procurement markets).
20. See the "legitimacy-granting" effect discussed in the previous section, which raises the chances of survival for firms that initially follow a pioneering firm into a new market. This makes the appropriate role for government trickier. Efforts might focus on helping some initial firms break into a new market, after which point additional effort might even be counterproductive. Government might help inform market entry decisions by reporting the number of firms and the general performance of those in the same target market. In this regard, recent mapping projects could



be useful in suggesting where other firms are active and where the Canadian brand might be more established.

21. In 2016, the new Liberal government announced a CanExport program (with funding of \$50 million over five years) to provide grants to SMEs that want to export, particularly to high-growth markets. This initiative also might help, but it is too early to assess its effectiveness.
22. The TPP is a 12-country regional trade deal that effectively would establish new free trade agreements for Canada with seven Asian-Pacific countries — Australia, Brunei, Japan, Malaysia, New Zealand, Singapore and Vietnam — in addition to updating trade rules for Canada's trade with the United States, Mexico, Chile and Peru.

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