Crisis Working Group Report: Business Continuity and Trade

Communiqué #9: Support Digitization of Small Businesses and Boost Interprovincial Trade

To help Canadian governments confront the public health and economic crisis resulting from COVID-19, the C.D. Howe Institute established several working groups to rapidly distill expert policy advice. The Working Group on Business Continuity and Trade is co-chaired by Dwight Duncan (Senior Strategic Advisor at McMillan LLP and former Ontario Minister of Finance) and Jeanette Patell (Vice-President of Government Affairs and Policy for GE Canada). Its membership includes industry experts and economists. Grant Bishop, Associate Director, Research, and Daniel Schwanen, Vice-President, Research, at the Institute support the group. Meeting regularly, it has identified and prioritized policy challenges and communicated members' views in published communiques. The group held its final meetings on June 16 and July 14, 2020.

With policymakers now focused on navigating economic recovery from the crisis, the working group's final discussions highlighted the importance of supporting recovery of the private sector and championing economic openness. Through the past months, the working group has noted the headwinds to recovery from diminished private investment and disruption of small businesses in particular. The group has consistently emphasized the degree to which a small economy like Canada's benefits economically from open trade and investment.

The final meetings highlighted these policy priorities:

- addressing vulnerabilities for small and medium-sized businesses;
- accelerating private-sector capital spending;
- reducing barriers to inter-provincial trade and mobility;
- resolving confusion around Canada's foreign investment review regime.

In the near-term, the working group observed the rapid pickup in economic activity as provinces have eased restrictions. However, it highlighted continuing uncertainties around the COVID-19 pandemic – especially the impact of a second wave – and the potential for recovery to stall after the current bounce.

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Based on aggregated credit card transactions, consumer spending levels through July are above year-ago levels.[1] Many economic indicators – particularly for materials sectors (metals, petroleum and non-metallic minerals) – remain depressed: through July, total weekly traffic for goods shipments on Canadian railways remained 10 percent lower than in 2019 and petroleum-sector drilling activity is 65 percent lower than in 2019.[2] Air travel also remains severely diminished, with traffic in Canadian airspace 71 percent lower than in June of last year.[3]

Measures for credit support and forbearance by creditors appear to have forestalled widespread insolvency, evidenced by the 15 percent year-over-year June decline in business bankruptcy filings.[4] Nonetheless, businesses have experienced significant disruption, and small businesses have borne the brunt of net employment losses across all industries (see Figure 1). Many small businesses will continue to face financial pressures from operating at under-capacity and incurring fixed costs for adaptation.

The headwinds facing the recovery increase the importance of measures to boost private-sector investment and facilitate domestic economic activity. In previous communiqués, the working group stressed that Canada faces the prospect of a protracted period of depressed demand for export-focused sectors.[5] Such depressed demand will, in turn, reduce capital spending in these sectors. This poses a significant risk for a prolonged period during which Canada's economy operates at under-capacity.

The working group believes that governments should consider measures to help small businesses transition – particularly to offset fixed costs of physically distanced operations and digitizing their operations and sales channels.

1 RBC Economics. COVID Consumer Spending Tracker (Updated August 10, 2020). Available online: https://thoughtleadership.rbc.com/covid-consumer-spending-tracker/.

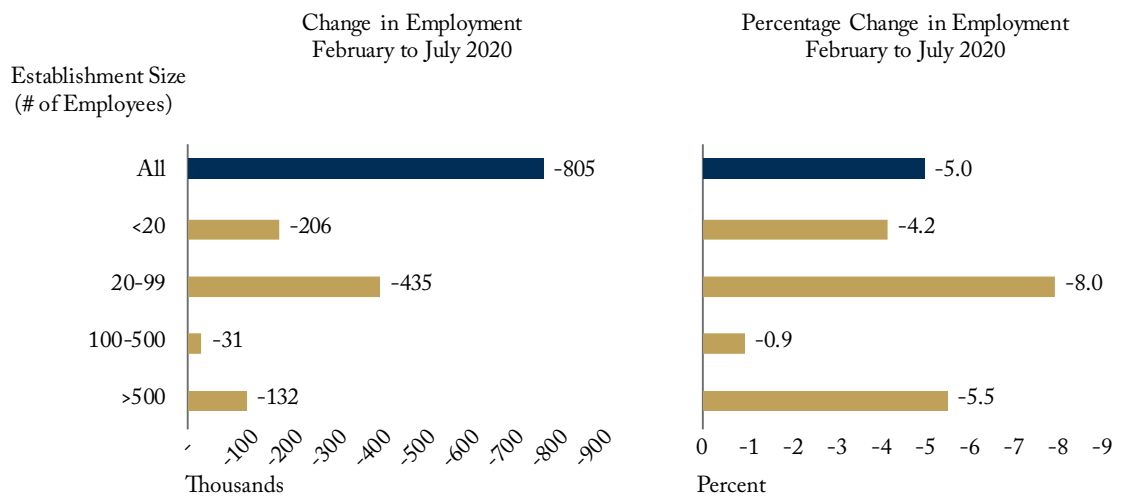
2 See indicators on C.D. Howe Institute COVID-19 Economic Dashboard. Available online: http://dashboard.cdhowe.org/.

3 NAV Canada. June 2020 Traffic Figures. Available online: https://www.navcanada.ca/EN/Pages/NR-31-2020.aspx.

4 Office of the Superintendent of Bankruptcy. Insolvency Statistics in Canada—June 2020. Available online: ic.gc.ca/eic/site/bsf-osb.nsf/eng/br04349.html.

5 C.D. Howe Institute Crisis Working Group on Business Continuity and Trade. 2020. "Financing Bridge Needed to Protect At-Risk Sectors as Canada Faces a Long, Hard Road to Recovery." May 19. Available online: https://www.cdhowe.org/council-reports/financing-bridge-needed-protect-risk-sectors-canada-faces-long-hard-road-recovery.

Figure 1: Employment Losses by Firm Size



Source: Statistics Canada - Labour Force Survey (Table: 14-10-0067-01).

The working group also highlighted the importance of access to capital for Canadian firms and the reduction of inter-provincial barriers to trade and labour mobility.

For internal trade, present circumstances amplify the urgency of overdue reforms to enhance labour mobility between provinces. Facing a volatile and uncertain international setting, Canada must facilitate economic activity at home. Reducing the challenges for skilled workers moving across provinces – for example, by automatically recognizing a trade certification from another province – can boost overall output significantly.

Regarding external trade, members noted that confusion around foreign investment reviews serves as a barrier to capital at a critical time for restructuring of financially distressed Canadian companies and private-sector investment.

Retool Relief Programs and Enable Digital Adaptation to Support Small Business Recovery

Through the recovery, many small businesses face elevated fixed costs related to the pandemic along with reduced volumes, resulting in continuing financial stresses. And many small firms face the

challenge of rapidly retooling their business models – particularly facing the need to digitize operations and sales channels.

Members noted that a recent report by RBC, "Small Business, Big Pivot," underscored the vulnerability of small firms through recovery amid the challenges of curtailed demand, disrupted spending patterns, costs of adapting for physical distancing, and pressures to rapidly digitize operations.[6] To support small business adaptation, this report recommended governments streamline relief programs, invest in safe reopening capacity, and support adoption of digital tools by small businesses – particularly to enable international reach.

Working group members viewed the retooling of relief programs – particularly restructuring the Canadian Emergency Relief Benefit (CERB) and extending the Canada Emergency Wage Subsidy (CEWS) – as important measures to facilitate hiring by small businesses during the recovery. To this end, the C.D. Howe Institute has published a survey of options to address perverse incentives under the current CERB design.[7]

With respect to digital adaptation, many working group members agreed that the pandemic had amplified the "change or die" imperative for firms. These members highlighted that government must be wary about subsidizing firms that have lagged on digital adoption and interfering with "creative destruction" within sectors, as more nimble and creative firms gain market share. To target support to high-potential firms and ensure discipline for these investments, various working group members urged governments to design small business support for digital investments using tax credits or in a manner that leveraged private capital.

Consider Measures to Accelerate Private Capital Investment

With Canada facing a potentially prolonged period of depressed demand, economy-wide, working group members considered several measures to accelerate capital spending in the private sector. Certain working group members observed that arrangements through the Large Employer Emergency Financing Facility or similar channels could be structured to encourage companies to accelerate planned capital spending.

6 RBC Economics. 2020. *Small Business, Big Pivot*. June 11. Available online: https://thoughtleadership.rbc.com/five-ways-to-help-small-business/?utm_source=event&utm_medium=vanity&utm_campaign=ent_smallbusinesspivot.

7 Laurin, Alexandre, and Ben Dachis. 2020. "A Stimulus Plan to Restart the Job Market," C.D. Howe Institute Intelligence Memo. May 20. Available online: https://www.cdhowe.org/intelligence-memos/laurin-dachis-%E2%80%93-stimulus-plan-restart-job-market.

For example, the working group considered a proposal to accelerate manufacturing of components by suppliers to the Bruce Nuclear Power Plant refurbishment. Many of these suppliers face reduced orders for other products in the immediate term but have contracted to deliver components for the Bruce refurbishment in future years. Accelerating manufacture of those components would fill idle capacity and help suppliers bridge a period of depressed demand. However, since the refurbishment will not require the components for several years, the suppliers will require subsidized repayable loans to incur the immediate expense of production and warehousing.

Certain working group members saw some merit to such financial assistance to accelerate production for already-committed projects. Government loans could help boost near-term private-sector output with negligible repayment risk.

However, other working group members observed that actions by central banks had already significantly lowered borrowing costs for private firms. They cautioned that governments should avoid interfering with signals about the credit worthiness of individual firms or with market-based decisions about when and what to produce.

Boost Resilience through Increased Internal Trade

Working group members that the crisis raises the urgency for an overdue reduction in internal trade barriers. Enhancing labour mobility across the federation can facilitate recovery from the pandemic as well as increase Canada's resilience to future shocks.

In particular, modelling by working group member, Trevor Tombe, has illustrated that reduction in costs for inter-provincial labour mobility (such as recertification in the destination province) can dramatically increase migration across provinces and boost output by better matching of skilled workers to jobs.[8]

More broadly, reduction in barriers to inter-provincial trade can significantly boost output in key sectors – particularly financial services, retail, transportation and agrifood.[9]

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8 Tombe, Trevor. 2020. "Potential Gains from Provinces Easing Labour Mobility Barriers," C.D. Howe Institute Intelligence Memo. June 29. Available online: https://www.cdhowe.org/intelligence-memos/trevor-tombe-%E2%80%93-potential-gains-provinces-easing-labour-mobility-barriers.

9 Alvarez, Jorge, Ivo Krznar, and Trevor Tombe. 2019. *Internal Trade in Canada: Case for Liberalization*. IMF Working Papers. July 22. Available online: imf.org/en/Publications/WP/Issues/2019/07/22/Internal-Trade-in-Canada-Case-for-Liberalization-47100.

Liberalization of internal trade can be accomplished though unilateral measures by an individual province to recognize certification or standards from other provinces. Modelling shows substantial gains for an individual province from such unilateral liberalization.

Reforms to the Canadian Free Trade Agreement (CFTA) could also improve incentives for private parties to challenge regulatory restrictions on trade between provinces.[10]

Working group members agreed with the urgency of enhancing internal trade and generally favoured measures to reduce barriers between provinces. Certain members pointed to examples of industries – such as agrifood – in which heightened costs for accessing inputs had hindered investments in processing facilities.

However, members doubted that barriers to internal trade could be rapidly reduced. These members highlighted the practical complexities of resolving the many regulatory differences between provinces and the political challenge of accepting standards from another province.

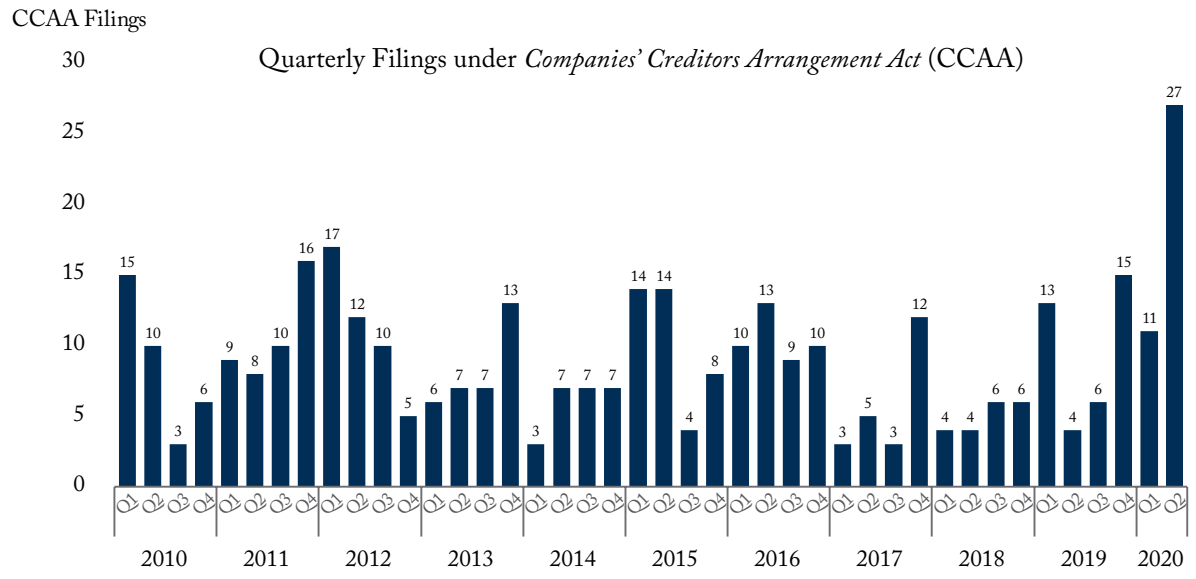
Clarify Canada's Openness to Foreign Investment

Working group members agreed that access to foreign capital will be critical during a period of intensified restructuring for Canadian businesses. While filings under the *Bankruptcy and Insolvency Act* have slowed during the pandemic, filings of large corporate restructurings under the *Companies' Creditors Arrangement Act* (CCAA) in the second quarter of 2020 far exceeded those for any quarter in the previous decade (see Figure 2).

To fund the turnaround of distressed Canadian assets – notwithstanding new investment – companies must have access to capital from foreign sources. Protracted approval processes and stringent conditions on foreign acquisitions of Canadian assets risk hindering Canadian access to foreign capital at a critical time.

10 Manucha, Ryan. 2020. "Ten Recommended Reforms for the Canadian Free Trade Agreement," C.D. Howe Institute Intelligence Memo. Available online: https://www.cdhowe.org/intelligence-memos/ryan-manucha-%E2%80%93-ten-recommended-reforms-canadian-free-trade-agreement.

Figure 2: Large Corporate Restructurings



Source: Office of the Superintendent of Bankrutpcy (CCAA Records List).

Given a recent statement that implies enhanced scrutiny of "opportunistic investment behaviour" by foreign acquirers,[11] working group members recommend that the federal government clarify its openness to foreign investment and approach to reviews under the *Investment Canada Act* (ICA). In particular, the government's recent statement on the ICA leaves unclear its definition or criteria for what "critical sectors" will be subject to enhanced reviews. From the government's statement, it is not clear that the scope of national security is being construed more broadly than traditional security concerns to contemplate concerns of a more economic nature (e.g., strategic technologies). The statement therefore raises the prospect that a broadened set of sectors could be subject to lengthy national security reviews under the ICA. A lack of clarity risks deterring foreign acquirers and Canadian firms' access to capital.

11 See: "Policy Statement on Foreign Investment Review and COVID-19," April 18, 2020. Available online: https://www.ic.gc.ca/eic/site/ica-lic.nsf/eng/lk81224.html.

To this end, various working group members agreed with arguments, recently advanced by John Knubley and Lawson Hunter, that the federal government should (1) increase the timeliness of national security reviews, (2) clarify its definition for "critical sector", and (3) involve the deputy minister of finance or innovation in national security reviews under the ICA.[12]

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Brian Livingston, Executive Fellow, University of Calgary School of Public Policy.

Ryan Manucha, Frederick Sheldon Fellow, Harvard University.

James Scongack, Executive Vice-President, Corporate Affairs, Bruce Power.

12 Knubley, John and Lawson Hunter. 2020. "Three Principles for Tougher Foreign Takeover Reviews," C.D. Howe Institute Intelligence Memo. August 4. Available online: https://www.cdhowe.org/intelligence-memos/knubley-hunter-%E2%80%93-three-principles-tougher-foreign-takeover-reviews.