

January 2001

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Recommended Citation

Ron A. Straatsma, *Competition between States and Provinces for New Investment: The Effect of Cross-Border Incentives on Plant Location--An Ohio Perspective*, 27 Can.-U.S. L.J. 163 (2001)

Available at: <https://scholarlycommons.law.case.edu/cuslj/vol27/iss/29>

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COMPETITION BETWEEN STATES AND PROVINCES FOR NEW INVESTMENT: THE EFFECT OF CROSS BORDER INCENTIVES ON PLANT LOCATION – AN OHIO PERSPECTIVE

Ron A. Straatsma^{*}

Introduction

This paper will analyze three main areas to gain insights into the effectiveness of economic incentives in determining cross border plant location decisions in the case of attracting Canadian direct investment to the State of Ohio. The author is an economic development representative for the State of Ohio charged with promoting the state as a business expansion destination for Canadian business.

Firstly an overview of Canadian and American trading patterns over the decade of the 1990's is made. In addition a view of the stocks of direct investment held by both countries in their partner's economy is outlined.

Next, an analysis of Canadian investment in Ohio is presented. In particular the origins of larger Canadian subsidiary operations within the state is reviewed to interpret the importance of economic incentives in the investment process.

Finally, the incentive programs offered by the State of Ohio are reviewed. The estimated total value of these incentives versus the total stock of investment added to the state economy during 1998 is examined.

The results would indicate that although Ohio incentives can offer significant benefits to Canadian firms, and all firms in general, their relative importance is minimized. This is in large part due to the cost structures manufacturing firms face in their on-going operations. Incentives reduce the overall level of taxation that a firm faces; however, taxation represents a small portion of on-going costs. Labor costs represent the majority of such costs. Since incentives have a term limit as well, their impact is reduced even further.

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From a larger perspective the rapid growth of bilateral trade between Canada and the United States has contributed to strong growth in the stocks of direct investment held by each country in their partner's economy. Trade promotes direct investment especially for Canadian firms seeking to solidify markets in the United States. A counter acting force has been the relative weakness of the Canadian dollar versus the US currency. This has enhanced Canada's competitiveness as a manufacturing base.

Finally when Canadian investment in Ohio is examined, it was found that most firms with significant employment in their Ohio subsidiaries acquired their Ohio production capacity. As Ohio's incentive programs do not typically have much to offer in the case of an acquisition, it is surmised that strategic motives lie behind the investment.

I. A General Analysis of Trade flows and Direct Investment Stocks Between Canada and the United States.

Bilateral Trade Flows

An examination of trade flow data between Canada and the United States as well a review of the stock of direct investment which each country holds in its neighboring economy, is a useful starting point in understanding the economic landscape in which cross border plant location decisions are made.

During the decade of the 1990's the process of Free Trade between Canada and the United States was completed with profound effects especially on Canada. Gaining unfettered access to the colossal American economy provided enormous opportunities for Canadian firms. Firms on both sides of the border now had the opportunity to rationalize production to meet demand in both countries. Rationalization was and is especially true for American companies that closed or redesigned branch plant production facilities in Canada.

The data over the decade show the rapid growth of two-way trade and in particular the evolution of the integration process of the Canadian economy into the American economy.

Nominal Canadian Exports to the United States increased from \$111 Billion C\$ in 1990 (74.8% of total Canadian exports for that year) to \$308 Billion C\$ in 1999 (or 87% of total Canadian exports for that year). During the

same period while Canada's Gross Domestic Product grew by 41%, its total exports more than doubled (138% growth) and the proportion of exports destined for the US almost tripled (177% growth).

As a proportion of the Canadian economy, exports to the United States in 1990 represented some 16% of Canadian Gross Domestic Product for that year, while in 1999 this figure grew to 32%.

For its part, the share of American exports to Canada grew at a more sedate pace from representing 64.5% of total Canadian imports in 1990 to 67.3% in 1999. Even so the dollar volume of Canadian imports from the United States grew from C\$ 88 billion in 1990 to C\$ 215 billion in 1999, a 144% increase.

In Ohio's case, its exports to Canada represented 41% (US\$7 billion) of its total exports in 1991. In 1998 sales to Canada grew to 50% of total exports (\$13.6 billion). The overall export pie had grown by 60% during the period, from \$16.8 billion to \$27 billion, while exports to Canada nearly doubled.¹

One must also consider the value of the Canadian dollar with respect to its American counterpart as an important component of the economic landscape. The declining value of the Canadian dollar during the 1990's certainly promoted exports from that country to the United States over the decade and conversely can be seen as being a break to greater American export penetration in Canada.²

Direct Investment Stocks

The stocks of direct investment held by Canadians and Americans in their counterpart's economy is a direct representation of plant location decision making on a broad basis. In Canada's case its total foreign stocks grew from \$109 Billion in 1991 to \$257 billion in 1999, a 137% increase over the decade. The proportion held in the United States grew a slightly less impressive rate of 112% during the decade to \$134 billion from \$63 billion in 1991.

¹ Ohio data can be found in the Ohio Department of Development, Office of Strategic Research Annual Report, *Exports with Ohio as State of Origin of Movement* (last visited September 29, 2001) <www.odod.state.oh.us/osr/economy.htm>.

² Statistical Reports from the Government of Canada Department of Foreign Affairs & International Trade, *Annual Historic Economic Indicators* (last visited September 29, 2001) <www.dfait-macci.gc.ca/eet/stats-e.asp>.

Within Canada, American ownership of Canadian business grew from \$86 billion in 1991 to \$173 billion in 1999, a 101% increase. American investment has increased as well. In 1991 the American firms held 64% of all foreign direct investment in Canada, while in 1999 this figure reached 72%.³

Inferences

The tremendous growth of the 1990's in bilateral trade and reciprocal direct investment holdings between Canada and the United States suggests a strong correlation between trade flows and investment decision-making.

From Canada's perspective freer access to the world's largest market coupled with an increasingly favorable exchange rate, drove the export boom. Canadian firms found their cost of doing business decreasing relative to their American competitors and what was more, sales in the United States earned valuable American dollars, which repatriated into ever more Canadian currency. The exchange rate had become and still is a significant incentive for manufacturing products in Canada.

The strong growth of Canadian direct investment in the United States indicates the above inference is not a complete explanation of plant location decisions on the part of Canadian business. One substantive reason centers on the notion that undertaking investment decisions primarily on the basis of exchange rate movements is a very risky endeavor indeed. While Canadian business can take advantage of favorable currency rates in the short term, these conditions cannot be relied upon for longer periods. It would then appear that Canadians expanded operations in the United States to support increasing trade flows and better serve the market south of their border. Increased trade acted as a catalyst for increasing investment. Also, expansion opportunities especially in the case of acquisitions would be much greater in the United States than in Canada. There are simply more players in any given industry in the American market.

For American firms the marked increase in Canadian investment during the 1990's could stem from two issues. Free trade did bring rationalization to the branch plant business model of old where American subsidiaries basically produced only for the Canadian market. In the new free trade era however such investment could be reinvigorated to produce specialized product

³ Statistical Reports from the Government of Canada Department of Foreign Affairs & International Trade, *Canada's International Investment Position 1999* (last visited September 29, 2001) <www.dfait-maeci.gc.ca/eet/stats-e.as>.

for all of North America or even the world. These businesses could enjoy the same currency benefits as Canadian producers: namely, operate in a Canadian dollar cost environment, and sell the bulk of product in the United States. The declining value of Canadian currency also had another major effect. It made the price of Canadian business assets relatively cheaper for American companies wishing to acquire more capacity in their industry. The result was the continuing dominance of American investment as a proportion of total foreign investment in Canada.

II. Canadian Investment in Ohio

Canada represents the fourth largest single country source of foreign direct investment in Ohio in terms of number of establishments and is seventh in terms of employment. There are 92 Canadian companies operating 108 subsidiaries in Ohio employing some 7,180. By way of comparison Ohio is home to 854 foreign owned entities that employ 195,000 people within the state. As of December 2000 Ohio had an employment level of 5.6 million people including 1 million in the manufacturing sector.

Foreign investment in Ohio is dominated by the manufacturing sector where 79% of its employment exists. Canadian investment is consistent with this trend as well with major industries such as: transportation equipment, industrial machinery, and electronic equipment.⁴

The State of Ohio tracks new investment into the state as well as expansion investment projects of existing companies. The data for Canada over the period 1996 through 2000 follows below. Canadian investment projects are typically of small to medium scale on an individual basis. During the 5-year period in consideration there were 19 projects identified. Twelve projects were expansions of existing operations in Ohio while the remaining seven were new investments in the state. Three projects resulted in an investment of greater than \$15 million each. In 1997 one new investment totaled \$74 million accounting for the significant increase of that year. All told Canadian companies invested some \$165 million in Ohio during the second half of the 1990s.

It is useful to compare the levels of Canadian investment to total foreign investment during the 1997 – 2000 period. In each year it is readily evident

⁴ Ohio Department of Development Office of Strategic Research, *Foreign Corporations with Operations in Ohio* (last visited September 29, 2001) < www.odod.state.oh.us/osr/reports.htm >.

that the Canadian component in overall foreign investment in Ohio is relatively small. A triumvirate of countries perennially dominates the Ohio foreign investment scene: Japan, Germany, and the United Kingdom.⁵

Motives Behind Canadian Investment in Ohio

There are 108 Canadian subsidiary operations known in Ohio operated by 92 Canadian parent firms. As noted a large majority are manufacturing operations. 24 Canadian companies employ more than 100 in their Ohio operations. An examination of the motives behind these larger scale investments will go some way in determining the importance of incentives in investment decision-making on the part of Canadian firms.

Employment is used as a proxy for size of investment as the monetary figures of actual investment are not consistently available for each firm. These 24 firms employ 5,207 out of 7,180, or 73% of total Canadian subsidiary employment in Ohio. The firms are divided into the three following groups. Details concerning each firm can be found in Appendix A.⁶

Acquisition Group

Canadian firms in this group acquired existing companies in Ohio as a means to expand into the American market. By and large one can infer that these acquisitions were primarily based on the attractiveness of the target company. Economic incentives would play a minor role in the acquisition decision. Indeed acquisitions would not even attract incentives unless significant expansion was present.

This group represents the largest set of Canadian companies with significant employment in Ohio. These 15 companies with 21 subsidiary locations in Ohio employ 3,337 or 46% of all 7,180 Canadian subsidiary employees in Ohio. Nine of these fourteen Canadian firms are known to have additional facilities in other American states.

⁵ Ohio Department of Development Office of Strategic Research, *Ohio Site Selection Report: Business Expansions and Attractions* (last visited September 29, 2001) <<http://www.odod.state.oh.us/osr/reports.htm>>.

⁶ See Ohio Department of Development Office of Strategic Research *supra* note 4.

New Investment to Ohio Group With Additional US based Subsidiaries

This set of larger scale Canadian investment in Ohio is made up of 7 firms with 8 subsidiary locations in the state. Collectively they employ 1,360 or 19% of all 7,180 Canadian subsidiary employees in Ohio.

Here again it would seem appropriate to posit that investment intentions were based primarily upon expanding market access in the United States and better servicing customers within a regional market.

Sole American Investment in Ohio Group

The two remaining Canadian companies examined have thus far located all their US expansion activities in Ohio. One firm located in Ohio for strategic reasons, that is, to gain close access to its US customers in the steel industry. The reasons behind the other firm's investment are unknown. Combined these two firms employ 510 in their Ohio subsidiaries or 7% of all Canadian subsidiary employment in Ohio.

Small Scale Canadian Investment

The remaining 68 Canadian companies, which collectively employ 28% of all Canadian subsidiary employment in Ohio, were not considered. Each company's Ohio employment did not reach 100 and many operate one Ohio subsidiary with employment well below the 100 level. Such smaller investments typically do not attract significant incentives from the State of Ohio.

III. Economic Incentives Offered by the State of Ohio

The State of Ohio offers a variety of incentives, which are made available to new businesses coming to Ohio and to existing business within the State. The incentives are all based on the new level of investment being made in the State or the expanded investment of companies already operating there. A brief overview of Ohio's major incentives programs follows.⁷

⁷ For more details consult *Taxes, Credit and Finance* (last visited September 29, 2001) <www.resourceohio.com/fr-bda.html>.

Tax Credits

Jobs Creation Tax Credit - If a business can substantiate the addition of 25 or more jobs over a 3-year period, the state can credit the company on a percentage of Ohio income tax withheld on new employee earnings for up to 10 years. On average this represents 1 to 2% of payroll annually. A company applies for the credit prior to project commitment.

Manufacturing Machinery & Equipment Tax Credit - New equipment purchases are eligible for a 7.5% or 13.5% tax credit spread over 7 years. Of maximum benefit to new investors in Ohio as all equipment is eligible. Existing company sites can claim only costs exceeding a three year historical average. Credit obtained during annual tax filing.

Property Tax Abatement

Communities in Ohio levy two types of property taxes. Real property taxes are levied against the value of land and buildings. Tangible property taxes are levied against equipment and inventory. Abatement is negotiated with community prior to investment.

Enterprise Zones - Exist in many areas of the state. Communities can abate both Real and Tangible Property tax up to 100% for 10 years.

Major Lending Programs

Ohio Enterprise Bond Fund - Up to 90% of project costs to a \$10 million maximum at a fixed rate for up to 15 years. A company can take advantage of the state's access to bond financing and its high credit rating. Financing is typically based on \$50,000-\$75,000 per created job.

Direct Loan (166) - Can provide funding of up to \$1 million at low rates, currently 4%-5%. The state will finance up to 30% of a project and typically bases funding on \$15,000 per job created.

Regional Loan (166) - Can provide funding of up to \$350,000 at low rates, currently 4%-5%. The state will finance up to 40% of a project and typically bases funding on \$35,000 per job created.

Grant Programs

Ohio Industrial Training Program - Up to \$100,000 annually but not more than an average of \$500 per employee can be claimed for instructor costs, materials, instructional media, and training equipment.

Road Work Development Grants - Funds are used to improve access to company facilities

Business Development Grants - Pool of funds available to assist selected company investment

Analysis of Overall Investment in the State of Ohio and Levels of Incentives

The State of Ohio Department of Development collects data concerning new and expanded business within Ohio from a variety of sources. The criteria required for a project to be noted in any given year are at least one of the following:

A minimum investment of \$1 million

A facility size of at least 20,000 square feet

Job creation of 50 or greater

Year	Number of Projects	Total Investment
1997	1,202	\$8.2 billion
1998	1,153	\$6.3 billion
1999	1,075	\$8.2 billion

It is instructive to relate the number of businesses which received some form of economic incentive and compare those benefits, where available, to the entire amount of investment made for the year. Note that incentives apply to both the expanded investment of existing facilities as well new facility investment.

In the company count figures below no account is taken for firms, which benefit from multiple programs. Benefits are however program based, thus no double counting occurs. The following aggregation of incentives should be viewed as an approximation only. In particular the benefits of multi-year abatement and credit programs should not be considered completely accu-

rate. Especially in the case of property taxes where equipment values depreciate over time, the amount of tax paid will reduce as the value of equipment reduces on a depreciated basis. The purpose of aggregating the incentive data is to come up with an order of magnitude of annual benefits relative to total investment for a given year. 1998 is the chosen year.

Property Tax Abatement - Ohio Enterprise Zone Program (EZ)

341 companies benefited from new EZ agreements in 1998 on projected investment of \$4 billion. On average 68% of property taxes were abated for a 9 year period

To estimate the dollar benefit of this incentive: Assume 20% of the investment was in Real Property, which faces an average Ohio mill rate of 52.15. 80% of the investment represents investment in Tangible property, which faces an average Ohio mill rate of 72.42 (1 mill = \$1 in tax / \$1000 of taxable property).⁸

Real Property - \$800 million of value has a taxable value of 35%, or \$280 million. The average net tax mill rate of 52.15 is assessed on the taxable value, resulting in taxes of \$14.6 Million.

Tangible Property - \$3.2 billion of value has a taxable value of 25%, or \$800 million. The average mill rate of 72.42 is assessed on the taxable value, resulting in taxes of \$59.36 Million.

Thus the total property tax payable on the \$4 billion in investment would be \$73.9 million in the first year.

The average abatement in 1998 was 68% yielding a first year benefit of \$50.3 million. The average term for this benefit in 1999 was 9 years, yielding a total benefit much higher than the first year figure, although declining each year as equipment values on which part of the taxes are based depreciate.⁹

⁸ 1999 Ohio Enterprise Zone Annual Report (last visited September 29, 2001) <www.ododstate.oh.us/ezone/annual-reports.htm> (show total investment abated from 1982 - 1999 in 2,983 agreements to be \$6.5 billion (20%) in Real Property and \$22.6 billion (80%) in Personal Property).

⁹ *Id.* 1998 Ohio Enterprise Annual Report.

Job Creation Tax Credit

During 1998, 119 companies were approved for this credit with a commitment to create 10,879 jobs. To impute a dollar benefit for this credit the August 1998 average annual industrial wage in Ohio of \$34,788 is used. Such income would be taxed at a rate of approximately 3% in Ohio, which is the amount on which the credit is based.

Assuming an average credit of 55% of employee withholding taxes for new jobs created, the overall cost of the program for 1 year would be:

10,879 jobs x \$34,788 (average annual income) x 3% (average tax rate) x 55% (average credit percentage granted).

This results in an annual tax savings of \$6.24 million. If one assumes the average life of the credit is 6 years then the total benefit to current year investment would be \$37.47 million.

Machinery & Equipment Tax Credit

715 Ohio based companies intended to purchase some 3.9 billion in equipment during 1998. The total value of the credit for this investment is \$293 million spread over 7 years or \$41.8 million per year.

Grant Programs

In 1998 the Ohio Industrial Training Program granted \$5.6 million while \$7.5 million in Business Development grants were awarded. The Road Work Development fund provided \$6.6 million.

Bond & Loan Financing

During the year 1998, companies received financing of \$83 million: \$56 million in 166 Loans, \$8.2 million in 166 Regional loans, and \$18.8 million in Ohio Enterprise Bond Funds.¹⁰

The above suggests that incentives can offer significant savings to businesses investing in Ohio. In particular tax credits and property tax abatement programs when combined offer a solid benefit. The multi year benefit also

¹⁰ Ohio Department of Development Press Release January 8, 1999, 'State Development Director Announces Preliminary Business Growth and Expansion Figures for 1998.'

needs to be stressed. A single investment in capital or labor continues to enjoy abatement for the life of the agreement.

Estimated Benefits to Companies Investing \$6.3 billion in Fixed Assets in Ohio –1998*

	First Year Benefits	Total Multiyear Benefits
Property Tax Abatement Estimate	\$ 50 million	\$ 450 million (9 year average credit) **
Machinery & Equipment Tax Credit	\$ 41.8 million	\$ 293 million (7 year credit)
Jobs Creation Tax Credit Estimate	\$6.24 million	\$ 37.4 million (6 year average credit)
Grant Program Funding (One Time)	\$ 19.7 million	\$ 19.7 million
% 1998 Program Benefits to 1998 Total Investment	1.9%	12.6%

* Loan financing not included (\$83 million in 1998)

** Depreciation of assets not considered

The limited amount of grant funding when considered relative to the size of total investment suggest a minor role. Financing programs were also relatively minor and of course have much smaller net benefits to business given the requirement to repay principal and interest.

A substantive study of incentives in Ohio was conducted in 1998 and measured the effect on net taxation rates before and after the application of Enterprise Zones, Job Creation Tax Credit, and Machinery and Equipment Tax Credit.

On weighted average across industries, the combined effect of all three major Ohio incentives reduced the net tax rate in Ohio from 43.1% to 36.5%, which represents a 15.3 % reduction in taxes. The study considered effective tax rates to be the sum of federal, state, sales and property taxes attributable to a

new plant located in Ohio. 8.6% of the total 15.3% tax savings was attributable to property tax abatement, which would make the Enterprise Zone program the single most important incentive that Ohio offers.¹¹

With Ohio's major incentives being tax based, it is important to determine the relative important of tax abatement in the decision making process of business.

A 1999 KPMG study The Competitive Alternatives: A Comparison of business costs in North America, Europe and Japan is cited.

When examining the relative importance of location-sensitive costs over seven manufacturing industries, the study cited Labor costs as by far the most important factor with taxation a distant second. 58% of ongoing costs are attributable to labor and benefits while 12% of costs are represented by income and non-income taxes.

The same study measures the effective income tax rate across nine industries for cities in many jurisdictions. In Ontario the average rate was 36.3% while the lone Ohio study city, Columbus, registered a 36.41% figure. These figures do not incorporate sales tax and property tax rates. The same study ranked costs of doing business in Canada as 7.8% below the US average. It should be noted the study utilized a value of the Canadian dollar at 0.667US and stated the Canadian cost advantage would be eliminated at an exchange rate of 0.787US.

Inference

If Ohio's major incentive programs can provide a combined effect to reduce taxation by some 15% as noted above, and taxation figures in the on-going costs of a manufacturing business at 12% then it can be construed that the net effect of incentives are in the order of 1.8% of total on going costs. This effect also dissipates over time at incentives expire.

Rationally speaking then, incentives should not form a major component of any investment decision. Furthermore non-monetary site selection factors such as access to suppliers and customers, skilled labor availability, highway infrastructure, etc., will diminish the importance of incentives even further.

¹¹ Ohio's Business Incentive Programs: Their Value to Firms and Their Effects on Ohio's Competitive Position. (last visited September 29, 2001) <www.senate.state.oh.us/horn/Fisher&PetersIncentivePrograms.pdf>.

APPENDIX A

CANADIAN COMPANY DETAILS OF THOSE FIRMS EMPLOYING 100 OR MORE IN SUBSIDIARIES WITHIN OHIO

Acquisition Group

ATS Ohio owned by ATS Corp. based in Ontario - Ohio subsidiary was acquired and subsequently expanded. This Canadian industrial automation company has multiple facilities in the United States and has grown primarily through acquisition. Employ 165 in Ohio.

BAE Systems with its headquarters in Quebec owns Cincinnati Electronics, a company it acquired in 1988. Aerospace industry. Employ 325 in Ohio

CAE with headquarters in Toronto acquired Ransohoff Inc. of Ohio. Employ 175 in Ohio.

CECO Environmental of Ontario acquired Kirk & Blum Manufacturing, which employs 250 in Ohio.

Canadian General Tower of Ontario acquired Texileather Corp. of Ohio. Produce fabrics for the automotive industry. Employ 350 in Ohio.

Consumers Packaging of Ontario owns Anchor Glass Container subsidiary in Ohio. Employ 190 in Ohio.

Dofasco Steel acquired Pioneer Powerlasers of Ohio where 100 are employed.

Dorel Industries, a Quebec based holding company, owns Ameriwood Industries on Ohio, which employs 300.

Extencicare of Ontario owns six acquired nursing care homes in Ohio. Have other facilities in the U.S. Employs 612 in Ohio.

Heroux-Devtek of Quebec acquired McSwain Manufacturing of Ohio. Employ 140 in Ohio.

Jax Mold & Machine of Ontario acquired two Ohio industrial molding firms: Caliber Mold & Machine and Athens Mold & Machine with combined employment of 125.

Magellan Aerospace of Ontario acquired Aeronca of Ohio. Recently made decision to stay and expand in Ohio rather than leave for another state. Incentives were an important part of that decision; however, original acquisition was not. Employ 250 in Ohio.

Transcontinental Printing of Quebec acquired Transcontinental Printing of Ohio, which employs 150 people. Transcontinental is a billion dollar printing force in North America with multiple US facilities.

Triac Industries of Ontario acquired DLM Plastics of Ohio. Employ 105 in Ohio.

Windsor Mold of Ontario acquired Autoplas Inc. of Ohio. Employ 100 in Ohio.

New Investment to Ohio Group With Additional US based Subsidiaries

Cantar-Polyair of Ontario employs 200 in Ohio. Multiple US facilities to better serve US markets.

Decoma International of Ontario built new facility in Ohio. This auto parts company locates facilities primarily based on proximity to automobile assembly plant customers. Quality of labor is also a key issue. Employ 350 at Norplas in Ohio.

Alcan Aluminum of Quebec has operated its American head quarters in Ohio for some time along with several production facilities. Employ 320 in Ohio.

Lynx Industries of Quebec have US headquarters in Ohio: Napoleon/Lynx employing 110.

• Canam Manac of Quebec owns Canam Steel of Ohio that employs 130. This structural steel maker has various US plants to serve local markets in each region.

Quebecor of Quebec owns Custom Direct Printing in Ohio employing 100. Quebecor has numerous US locations.

Woodbridge Group of Ontario owns Woodbridge Corp. of Ohio where 150 are employed. This auto parts maker also has a network of US based facilities

Sole American Investment in Ohio Group

Taylor Steel of Ontario has located two facilities in Ohio. Main reason for an Ohio presence was to better serve US customers of its steel service center capabilities. Employs 210 in Ohio

WC Wood Company of Ontario located a subsidiary in Ohio that currently employs 300. Investment intentions were not determined.