



LETTER FROM THE PRESIDENT

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Bold, aggressive policy needed to address the employment problem in Canada

HIGHLIGHTS:

The challenge for the March 2017 federal budget is to stimulate business investment for job creation.

Infrastructure spending will unlikely be a significant catalyst to provide needed economic momentum in the next several years.

Effective tax incentives are needed to stimulate capital formation and job creation in the small business sector. The successful track record of the UK Enterprise Investment Scheme suggests a Canadian version would be the optimal financing vehicle to assist the start-up and expansion of small and mid-sized businesses.

Federal Finance Minister Bill Morneau tabled the government’s second budget yesterday, March 22, 2017. The budget was billed as a blueprint for navigating an evolving economy amidst global uncertainty and sluggish growth. The objectives are to strengthen Canada’s innovative capacity, build a highly skilled workforce, and broaden workplace participation.

These are laudable objectives. However, they can only be achieved through increased capital formation in the economy, a quickened pace of business start-ups and the steady expansion of existing businesses, to create the needed jobs. Tax measures must provide the incentive for increased risk-taking by entrepreneurs and investors.

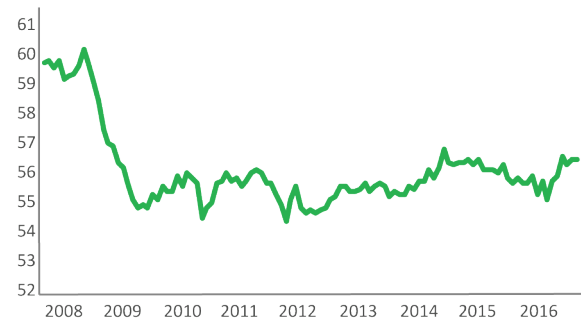
THE CHALLENGES FACING POLICY-MAKERS

The biggest challenge for calibrating federal fiscal policy is the current high level of uncertainty. There are many risks related to the direction of commodity prices, rising protectionist global trade sentiment, prospect of weaker-than-expected household spending and the possibility of a sharp upturn in global long-term interest rates. The budget planning exercise this year also coincided with the dramatic change in policy direction under the new Trump Administration, with emphasis placed on financial and environmental deregulation, lower corporate and personal tax rates, increased infrastructure spending and talk of trade wars. At this stage, the impact of anticipated and actual policy changes in the U.S. is hard to gauge, reflecting uncertainty about the precise policy mix, the timing of policy measures, and the magnitude of the policy changes contemplated, especially lower U.S. taxes on the attractiveness of Canadian portfolio and direct investment.

The Finance Minister is right to focus on job creation as the centre-piece of public policy. The unemployment rate has moved steadily lower since it peaked at 8.7%

in the summer of 2009, to an average rate of 7.0% in the last couple of years. However, the decline has been partly due to discouraged workers leaving the labour force, as illustrated by the decrease in the labour force participation rate. Many have given up searching for employment in a difficult economic climate. The average duration of unemployment has remained high, and is now higher than it was before the recession.

Employment Rate (%)
Young Canadians



Number of persons 15 to 24 years of age employed as a percentage of the population 15 to 24 years of age
Data Source: Statistics Canada

The employment picture can also be more clearly understood if examined through the prism of the employment rate—the ratio of Canadians employed relative to population 15 years of age and over.

The aggregate employment rate peaked in February 2008 and then fell sharply during the recession. It never recovered after that. There is a stark difference in the employment rate of young Canadians (15 to 24 years of age), and Canadians of prime working age (25 to 54 years of age). The employment rate of young Canadians dropped sharply during the recession and has not recovered since (see chart above), while the employment rate for Canadians of prime working age recovered, albeit remaining below pre-recession levels.

The federal government concluded from the outset of its mandate that significant deficit financing would be required to stimulate economic growth. The government is projecting a \$23.0 billion deficit in fiscal 2016-2017, and \$28.5 billion in fiscal 2017-2018. Further, the government projects annual deficits in the range of \$24 billion over the subsequent three years. In response to a worsening fiscal situation and the related uncertainty, the government has set the debt burden as its fiscal target, not balanced budgets. The plan is to reduce the public debt burden—the ratio of debt-to-GDP—below the current level by 2020-2021.

The decision to resort to deficit financings can be justified if the incremental benefits arising from it outweigh the negative long-term consequences for the economy—reduced national saving and income, higher government interest charges constraining future budget policy, and limited flexibility to respond to unforeseen events. Younger workers and future generations will be left responsible for repayment of the debt burden.

INFRASTRUCTURE SPENDING FIZZLES AS A STIMULUS

The dilemma for the federal government in this budget exercise is the fact continued deficit financing and a mounting public debt have not, at least so far, translated into faster economic growth and sustained job creation. In particular, substantial infrastructure spending has not had the expected impact on growth, nor is it expected to going forward. Indeed, a Senate Committee [report](#) titled “Smarter Planning, Smarter Spending: Achieving Infrastructure Success” found that of the \$13.6 billion in infrastructure spending planned for 2016-2017 and 2017-2018, only \$806 million worth of projects (or 6%) have actually commenced. It is clear many projects are not “shovel ready”, taking time to move from the drawing boards to commencement. The Fraser Institute [concluded](#) that only a small fraction of Ottawa’s nearly \$100 billion in planned infrastructure spending over the next decade, just 11 cents of every dollar, is earmarked for transportation and trade projects. Such spending can improve productivity and boost long-term economic growth. It appears that the large majority of public infrastructure spending is directed to “green” and “social” infrastructure. While these projects are well intentioned, they are unlikely to boost productivity and translate into sustained economic growth and jobs.

The federal government holds out hope that the new Canada Infrastructure Bank (CIB) will provide needed direction for federal and provincial government capital to identify and fund worthwhile projects, and attract additional private equity capital to these projects. However, it will take some time for the CIB to become operational, and its success will depend on the investment focus, quality of expertise and autonomy in implementation and operations, and accountability and transparency. Private sector infrastructure models, structured as public and private partnerships, offer an effective interim solution, but there seems little appetite to move in this direction, with focus concentrated on the CIB option.

In the near term, infrastructure spending will not provide the needed stimulus to the economy. This means federal policy should focus on mechanisms to stimulate business capital spending. It means reversing the steady cut-backs in capital spending in the past two years.

SMALL BUSINESS START-UP AND EXPANSION KEY TO JOB CREATION AND GROWTH

The real gains to growth will come from the expansion of small and mid-sized business in the resource and non-resource sectors. Policy measures should be open-ended to benefit companies and maximize employment growth right across the corporate sector. It is important to assist firms in the fast-growing technology area, but equally important to assist businesses in the manufacturing and service sectors.

The first order of business for government policy is to create the right business conditions to enable domestic enterprise to thrive and grow, and to attract off-shore firms and investment capital to the domestic marketplace. This means a concerted effort to ensure business and personal taxes are competitive; that regulations are kept to a minimum; and that access to export markets is secure.

In the budget, the government has rightly pin-pointed access to equity capital for growing businesses as a priority policy objective. While angel networks and private venture funds provide an effective source of capital for new and emerging small businesses, we can do better. Further, the real need is for improved access to capital for successful, growing mid-sized businesses in technology, manufacturing and services. We know that U.S. venture capital funds and U.S. technology companies scrutinize the best business opportunities in Canada for private equity investment, and are quick to pounce. However, once Canadian small businesses are in the maw of U.S. venture capitalists, it is only a matter of time until they shift operations to the U.S. and evolve into U.S. businesses, spinning off economic and job opportunities to Americans, not Canadians. Examples include Lululemon Athletica and Aritzia.

For the most successful, prominent Canadian small businesses, the migration south may be inevitable. But better access to private and public equity capital in domestic markets for many Canadian small businesses can make a difference, enabling many of these businesses to build and expand operations in Canada.

THE BUSINESS GROWTH FUND AND ENTERPRISE INVESTMENT SCHEME

In an effort to augment the sources of equity capital available to growing small and mid-sized businesses, the Finance Minister announced the launch of the \$500 million Canadian Business Growth Fund (to grow over time to as much as \$1.0 billion), backed by the large banks and insurance companies. Fund investments will typically range from \$3 million to \$20 million. The Fund is modelled on the success of the UK Business Growth Fund (BGF), financed by five UK banking groups (Barclays, HSBC, Lloyds, RBS,

and Standard Chartered). The BGF makes equity investment in private and AIM-listed companies usually between £2 and £10 million.

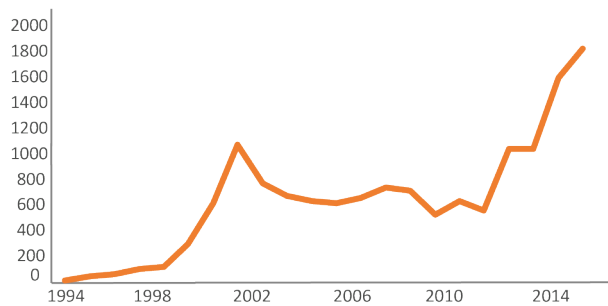
In the UK, the two successful programs to provide equity financing to new, emerging and growing small businesses are the BGF and the Enterprise Investment Scheme (EIS). In the budget, the federal government has opted to encourage participation in a Canadian version of the BGF, probably at the urging of its Economic Advisory Committee.

The more effective financing vehicle—generating far more equity capital for small business and in terms of identifying successful investment opportunities—would be a Canadian version of the UK EIS. For example, in the latest four years ending 2014-2015, EIS-financed companies raised about £5.5 billion in equity capital, ten times the amount undertaken by the BGF.

The EIS's appeal has grown over the years (see chart below). In the first four years of the Program in the mid-1990s, EIS annual financings totalled £100 million. It averaged £600 million in the subsequent ten years. In the latest four years, annual financings jumped to the £1.4 billion range. The program has funded about 25,000 small businesses in the UK, providing overall equity capital of more than £14 billion. Further, the EIS Program is dominated by small-sized investments, with 80% of the investors making a claim for tax relief for investments less than £50,000. This means the program is popular among individual investors.

Investments in EIS-qualifying shares of small business have a solid track record of success because the investor's own capital is at stake—unlike the professional fund manager. Many investors are knowledgeable and acquainted with the EIS-qualifying investments, as many of the businesses are local.

UK Enterprise Investment Scheme
Amounts Raised (£ millions)



Data Source: HM Revenue & Customs

The BGF was likely selected as the instrument of choice in Canada because it has proven an effective financing instrument in the UK, and because private sector financial institutions are providing the financing. The federal government neither makes a financial commitment, nor provides tax incentives. On the other hand, the EIS Program provides a 30% personal tax credit for EIS-eligible share purchases, an exemption from capital gains tax for EIS shares held

more than three years, and a rollover provision exempting capital gains taxes on the sale of an asset, if the proceeds are reinvested in EIS shares. The EIS Association estimates the tax expenditures of the Program are more than offset by the revenues generated from corporate taxes, taxes paid on salaries to employees, and VAT paid by EIS-financed companies.

The EIS Program was scrutinized and reviewed by Inland Revenue ten years into its operation, including its effectiveness in creating jobs for the UK economy. The outcome of the analysis was not only to keep the Program in place, but to expand it. The maximum annual investment allowance eligible for tax relief was increased from £100,000 to £500,000 over the 2008-2009 to 2011-2012 period, and then to £1million in 2012-2013.

CONCLUSION

The Canadian economy has been mired in sluggish growth. The outlook is clouded with considerable uncertainty, particularly the nature, timing and impact of U.S. policies under the Trump Administration, such as the push for lower corporate and personal tax rates, and the prospect of cross-border trade barriers.

Public policy in the March 2017 federal Budget has rightly focused on initiatives to stimulate capital formation and expansion of small and mid-sized businesses and create increased employment in beleaguered labour markets. The real need is to provide good job opportunities for young Canadians.

The measures taken in the March Budget, while well-intentioned, do not go far enough. The federal government needs to take bolder, more aggressive action through tax incentives to promote small business growth. A Canadian version of the proven UK EIS should be launched to direct more capital to small businesses. While incentives are integral to the success of the Program, the evidence from numerous studies indicates the EIS Program has been an effective and responsible financing vehicle for UK small business.

Yours sincerely,

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President & CEO, IIAC
March 2017