INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÉRES

Small is beautiful:

Bolstering Small Business in Atlantic Canada

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<u>Check against delivery</u>

Thank you for that kind introduction.

Today I want to talk to you about something that is important to all Newfoundlanders. To all Atlantic Canadians – and in fact to everyone in this country: the dynamism of small business in this province and this region.

I want to examine whether Newfoundland and Atlantic Canada are able to take maximum advantage of the potential of small business. I also want to discuss what roadblocks we need to remove to make it happen.

At the outset, I should congratulate Memorial University for making entrepreneurship a priority. The University's P.J. Gardiner Institute for Enterprise and Entrepreneurship offers expertise through several centres and programs. *Gateway Without Borders*, for example, connects Canadian companies with potential strategic partners and investors.

There is no question about the importance of small businesses to the economy. They are the largest creator of jobs. They generate tax revenues. And they serve as a magnet of opportunity for entrepreneurial individuals.

Here in Newfoundland and Labrador, for example, almost 96 percent of all workers are employed by small firms with fewer than 50 employees. .

But there is reason for concern. Small business has grown relatively slowly here in eastern Canada, compared to the rest of the country.

This is particularly troubling, given that the economy of Newfoundland and Labrador has been one of the fastest growing in Canada for the past five years. In that period, the GDP of Newfoundland and Labrador grew by over 22 percent. That's well ahead of the next two provinces – Alberta and British Columbia.

The Royal Bank of Canada projects that over the next two years, Newfoundland and Labrador will post higher GDP growth than any province other than B.C. or Alberta.

But these happy statistics do not translate into jobs in the small business sector. According to recent Canadian data, employment in businesses with 100 or fewer employees increased by 1.2 percent over the previous year.

But when you look at the regional figures, the results are considerably different. Here in this province, employment by small businesses increased by only one-tenth of a percent. In New Brunswick there was no increase. And in Nova Scotia and Prince Edward Island, small business employment actually declined.

What is more, the Atlantic region faces a challenge – a generational challenge faced by other regions but one that hits Newfoundland harder than the others. Not enough men and women are staying here to take over the helm of small businesses.

You are losing a lot of your homegrown talent. Newfoundland and Atlantic Canada are suffering from a brain drain – one that approaches crisis proportions.

Just consider a study conducted by the Canadian Federation of Independent Business. Business people in this region are finding it hard to find successors to take over their businesses. Baby Boomers are having problems finding Gen Xers to take over for them. This is a challenge across Canada: more than 70 percent of business owners surveyed said they plan to retire within the next 10 years. The majority of them are dependent on the proceeds from the sale of their business to fund their retirement.

The demographics create a huge problem. Consider the following:

- Business owners planning to sell will outnumber prospective buyers by a ratio of about 2:1!
- Small to medium size businesses represent 95 per cent of the employment in this country!

The situation will reach crisis proportions if the business owner's succession plan does not go well. It is crucial that Newfoundland and the Maritime provinces find ways to retain the best and brightest – and draw back those who have left. You need to attract Newfoundlanders back, as well as others to Newfoundland.

In this mission, you have some natural assets. People are drawn to their roots. I have found that the siren call of home is especially appealing to Newfoundlanders. You identify with your home culture, you show pride in it, whether you are here or thousands of miles away.

Moreover, you are better able to counter some of the economic factors that have drawn people away. Newfoundland's distance from economic and population centres, used to be a difficult factor to counter. But in the era of the Internet and relatively easy transportation, physical location is no longer as crucial as it was. Technology is the great equalizer.

With the playing field somewhat leveled, Newfoundland businesses have an opportunity to woo back homegrown talent. But it is important that government not stand in the way. Rather, government should put in place policies to help achieve what you need – a reverse brain drain that attracts Newfoundlanders back home and attracts others to make Newfoundland their home.

As well, we think there will be new opportunities to diversify the Newfoundland economy if certain changes are made. Oil and gas accounts for 16 percent of Newfoundland's GDP – compared to just 3 percent for Canada as a whole. The provincial GDP has grown by 44 percent since 1997. Almost half of that growth is directly attributable to oil and gas.

But the energy sector here in Newfoundland has been based on offshore resources – with the large capital costs that entails. The sector's growth has benefited small companies only through economic spin-offs, mainly in the service sector.

We saw that pattern in Alberta until the mid-1980s. The energy downturn then prompted integrated companies to sell off assets to small firms.

The Atlantic provinces must determine how they can leverage a growing energy industry to spawn small and medium-sized businesses. I just heard of one example before I came here – Mad Rock Marine Solutions Inc. It used Memorial University's Enterprise and Entrepreneurship Gateway to develop escape, evacuation and rescue solutions for companies involved in offshore oil production.

Now let me tell you about two challenges that small businesses will face: difficulties in financing and lack of investment advice.

Difficulties in financing is one of the biggest challenges that small businesses in Atlantic Canada face. In particular, consider the relative scarcity of venture capital and private equity financing.

The dearth of venture capital and private equity reflects Atlantic Canada's size, and the relative remoteness of the region's businesses.

Last year, venture capital investment across Canada amounted to $1.69 billion, slightly more than the year before. But venture capital dollars invested in Atlantic Canada came to only about 2 percent of the national total in 2006.

What about the pre-venture capital stage? That gap in start-up financing often must be filled by angel capital, provided by affluent individuals, often retired business executives. Newfoundland and the Atlantic provinces have a relatively small pool of angel investors.

We saw the founding of the first angel network in Atlantic Canada just two years ago. It now has about 50 members, based mainly in Nova Scotia and New Brunswick. When it comes to angel financing, the region has to scurry to catch up.

The other big gap in the region is the relative lack of local investment firms. Local investment firms are needed to provide local capital, and professional expertise and advice.

There are only four small local dealers in Atlantic Canada. All of them are based in Halifax. That compares to 37 firms headquartered in Western Canada – in all four of the western provinces.

The investment industry here in Atlantic Canada is focused on the wealth management business – providing advice and financial products for retail investors through branch networks of national firms. But these firms don't provide corporate underwriting and advisory services.

The small dealer sector is active and thriving in central and western Canada. Why is it unable to get off the ground here in Atlantic Canada?

First, we are seeing a classic chicken-and-egg problem. Local dealers establish and grow in response to an expanding small business sector. And they respond to investor demand for alternative local advisory services.

Second, the Atlantic region has relied overwhelmingly on large, bank-owned enterprises for business financing and retail wealth management services. Independent financial services companies have been slow to spring up.

In fact, only about one in nine independent businesses in Newfoundland and Labrador do *not* rely on bank financing, and finance internally through retained earnings or savings of the business owner.

How then can we encourage small business expansion in Atlantic Canada? How can we build the small dealer infrastructure that supports small business growth?

First, we have to take a hard look at our tax system. One of the reasons for Alberta's success in translating natural resource wealth into broader prosperity has been its zero sales tax. Companies in Alberta have an enormous advantage in that regard.

The federal government has demonstrated a commitment to economic growth in the Atlantic region. Last year, the Atlantic Canada Opportunities Agency spent $107.8 million in Newfoundland and Labrador. One has to wonder: What would be the impact if those resources were used to cut taxes for businesses? or used to provide business start-ups?

The Government of Newfoundland and Labrador has recognized the need to ease the tax burden. A good example is the province's Economic Diversification and Growth Enterprise program, or EDGE. New businesses or businesses with plans to expand are eligible for a range of incentives. These include a full rebate on some provincial taxes and a 50 percent rebate on federal taxes.

But in any such program, not all businesses are eligible. We have to look at the overall tax burden, both for individuals and companies, here in Newfoundland and across the country.

Just compare our capital gains tax rate with the United States. There is too little incentive for Canadians to invest and keep investing. We are taxed on 50 percent of our capital gains, at the ordinary income rate. And we make no distinction between long-term and short-term capital gains.

Compare that to the United States, where long-term gains are subject to a lower tax rate. In fact, the U.S. tax rate on long-term gains was reduced to 15 percent.

Newfoundland and Labrador has the highest combined marginal rate of tax with respect to capital gains, dividends, and ordinary income and interest.

Are we really providing the kind of incentives we need to compete? There are several potential measures to encourage investment by Canadians in all provinces, including Newfoundland.

We can reduce the tax on reinvested capital gains. This could be done by lowering Canada's effective tax rate on capital and increasing the capital cost allowance to better equal the rate of economic depreciation.

We can put in place special initiatives to encourage investment. For example, the federal and provincial governments can reduce the capital gains inclusion rate from 50 to 25 per cent for gains on initial public and treasury offerings of shares in small, publicly listed companies.

At the same time, we need to encourage private research and development spending. One way to do that is to extend the scientific research and experimental development tax credit program to firms listing on the TSX Venture Exchange.

We can put in place targeted tax incentives to increase funding in priority areas. The flow-through share concept, which permits resource-based corporations to issue shares to fund exploration and "flow through" the associated tax deduction could be extended to knowledge-based industries.

And just this week we heard about an extremely promising new structured product being developed, that with some government backing, will provide funding for new and emerging businesses. It is a principal-protected venture capital financing note that returns full principal at maturity but invests some of the funds in venture capital.

Business tax incentives are also part of the solution.

Streamlining securities regulation to relieve the regulatory burden on small business and dealer intermediaries is another.

Right now, we have a regulatory regime focused on process, and driven by a mass of detailed rules. Rules that don't really make a difference to investors.

Small public companies have been overburdened with too many prescriptive rules and listing standards that drive up the cost of capital. Small firms that decide to go public go through the same process as the big multi-million dollar companies. They need to complete a long and prescriptive document that typically runs about 90 pages. This document must be reviewed by a cadre of lawyers, accountants and other professionals. The expense to small companies becomes so prohibitive that they are often forced into the private market where they have a much narrower appeal to the bigger investors.

I should point out that the Canadian Securities Administrators, the umbrella organization of provincial and territorial administrators, has recognized the need to keep down the regulatory burden for small companies. Provincial and territorial regulators are working on a passport system to allow Canada's 13 securities regulators to recognize each other's decisions. Once a company satisfies the regulatory requirements in one jurisdiction, it would be free to raise capital in all of them. Also, the CSA did not extend the full audit requirements of the Sarbanes-Oxley Act to small issuers. Small companies have been spared the enormous audit requirements that were imposed on public companies in the United States.

But small companies still face huge regulatory costs when going to the public markets. Just a few years ago, the Prospectors and Developers Association of Canada added up what it would cost a mining company forced to register in two or more jurisdictions to raise $600,000 in capital. The tab came to $300,000. Half as much as they were trying to raise!

When it comes to addressing the concerns of the dealer side, the Investment Dealers Association has recently promised to re-write, in plain language, the by-laws, policies and regulations in the Rule Book.

But the problem isn't just the language of the regulations – it's the regulations themselves.

A principles-based approach to regulation would set the stage for increased capital and wealth creation here in Newfoundland and throughout Canada. Rather than allow the weight of a big rulebook to hold our economy back, we can determine the goals we want to achieve and put in place principles to get us there.

Ladies and gentlemen, Newfoundland and Labrador – and your neighbours in Atlantic Canada – has more potential for economic growth today than at any time in decades. But lasting wealth will depend upon the ability to encourage start-ups, and help small new businesses survive and thrive. It will depend on encouraging young people to stay here, and encouraging those who have left to return and attracting new people to the region.

The ability to raise capital is key to achieving these goals. And the ability to raise capital depends in large part on an effective tax code and an efficient regulatory structure.

You have the entrepreneurship. You have the resources. What you need now are the tax and regulatory reforms that will make it possible for you to turn opportunity into lasting prosperity.

Thank you.