Intelligence MEMOS

From: Ken Smart and Tim Runge

To: Canadian Productivity Watchers

Date: June 28, 2024

Re: **Risk Aversion is Hampering our Industrial Offset Policy**

The peace dividend enjoyed since the end of the Cold War has been suspended – though Canada appears to struggle with this emerging truth. Conflicts that many considered unthinkable, and threats previously dismissed as products of an overactive imagination are today's geopolitical reality. Though there is increasing support among government and the public for significant action, Canada continues to fall short.

In this new reality Canada has made a commitment to NATO that defence spending equivalent to 2 percent of GDP is the minimum required to meet our obligations toward collective security. This means an increase in the defence budget of $20 billion annually. As pressure for additional defence spending increases, economists warn that Canada's ability to create the wealth necessary to fund this increase, while maintaining social programs important to all Canadians, is in decline.

It is not, however, all doom and gloom. There are major opportunities amidst our defence spending challenges. Canada has defence procurement policy mechanisms available that can have an outsized impact on Canadian innovation, skills development, and job creation – the areas of investment critical to our long-term economic success. Canada's Industrial and Technological Benefits (ITB) Policy –known generically as industrial offset – is an important part of the government's economic toolkit.

ITB policy requires all companies awarded Canadian federal contracts, domestic and foreign alike, to "spend" one dollar in Canada for each contract dollar awarded. There are several ways that these companies can fulfill this obligation, including R&D, and technology commercialization investments in Canadian companies. ITB Policy, when intelligently and proactively applied, can create refined and focused investments with extremely beneficial impacts on the Canadian innovation landscape.

Risk aversion represents a fundamental challenge to the execution of successful ITB Policy and, we argue, to generating benefits to Canadian innovation and productivity. Defence contractors that fail to successfully execute promising, but risky ITB projects, generate little or no credit against their obligations and must then expend more resources to identify additional projects. Failure by the defence contractor to fulfill an obligation is not an option as significant penalties are built into contracts. As the saying goes, "No one ever got fired for buying IBM." What this means in the context of ITB Policy requirements is that defence contractors will generally seek ways to fulfill ITB obligations through low-risk projects that may run counter to long term wealth creation objectives in Canada.

Small and medium-sized businesses and startups with promising but nascent IP that present many of the greatest growth opportunities for Canada have a difficult time participating in some of the key "allowable transactions" under the policy.

For example, SMEs often cannot match the required funding from a defence contractor needed for an R&D consortium transaction. Such fund matching maximizes the ITB credit available to a contractor, lowers its overall costs, reduces risk, and provides the best credit return. Choices made by a defence contractor will always be those that pose the least risk and lowest costs. In other words, those responsible for fulfilling ITB obligations inside their respective corporations face less risk of getting fired for "not buying IBM" and are heavily incentivized to do so by our current policy.

If provided with the right incentives, these same contractors could be encouraged to make riskier, but potentially much more beneficial investments in support of Canadian innovation and wealth creation. These are precisely the kinds of risks that we should be encouraging defence contractors to take.

For example, despite years of effort Eomax, a small Toronto-based defence electronics company, has never been successful in securing a domestic ITB project. Though engaged in leading edge technology development in modular video systems, the kind of technology that can contribute to making Canada rich, its size and the risk profile of its projects have consistently been deemed unacceptable. (Full disclosure: One of the authors is president of the firm.) As a result, Eomax has ventured abroad, securing significant industrial offset-based financing for the development of innovative technology, ownership of which resides outside Canada, in essence because the Canadian ITB Policy discourages investment in such risky small businesses.

ITB Policy has evolved in many positive ways from its initial "build-to-print" subcontracting days when factories vanished when contracts ended. But Ottawa still needs to adopt a more venture-capitalist mentality. This means working with contractors to identify investment opportunities with heightened risk tolerance and an acceptance that some may fail, but that some may also go on to make a truly outsized contribution to our country.

In the new geopolitical reality, we have obligations to enhance collective defence as well as our own. But we also have an opportunity to extract more value from our coming defence spending increases. A chance to exploit the long-term economic and technological benefits that result from doing things both bold and different.

*Ken Smart is President of Eomax Cor, and Tim Runge is President and Partner at C&I Constructive Edge Inc.*

*To send a comment or leave feedback, email us at blog@cdhowe.org.*