Intelligence MEMOS

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To: Canadian tax authorities

Date: May 31, 2019

Re: **Leveraging Private Equity Energy to Fuel Small Business Development**

Canadian firms generate just 73 percent as much gross domestic product per hours worked as their US peers, down from more than 90 percent in the 1980s. At the same time, fewer small Canadian than US companies grow into larger businesses.

Indeed, a recent Business Development Bank of Canada study found productivity among small and medium-sized Canadian firms is particularly poor and that only 2 percent of mid-sized Canadian businesses, critical for domestic productivity, grew into large businesses with more than 500 employees.

There is solid evidence linking the productivity gap with this relative lack of small business dynamism. Policies that provide the best environment for Canadian firms to grow would help reduce Canada's productivity gap with the United States.

Canada has experienced a dearth of initial public offerings over the last 30 years, and owners of promising Canadian start ups and young companies often exit by selling their stakes to large foreign companies rather than grow the companies domestically.

One possible factor holding back firm growth in Canada is the insufficient availability of patient financing, which supports business development beyond the venture stage. In this context, it is natural to ask what source of capital (and associated expertise) could complement public equity in fostering firm growth in Canada – including by helping to bridge small and medium-sized Canadian companies toward that apparently elusive Canadian IPO.

In our new C.D. Howe Institute **paper**, we show that private equity capital (venture capital and private equity) plays a positive economic role, nurturing growth, jobs, investment, trade, and productivity in the Canadian economy. Governments, who have focused on nurturing the Canadian venture capital ecosystem in recent years, should leverage this beneficial role of private equity, by shifting their attention to mechanisms that can help firms grow or gain a more solid footing beyond the initial venture stage.

In that vein, we suggest three policy avenues that would boost the role of capital markets in supporting firm growth more generally.

First, the Department of Finance should consider exempting from taxation the capital gains realized on the sale of the shares of certain small businesses, similar to a measure adopted under the US Small Business Jobs Act of 2010. For investors to qualify for capital gains tax exemption, they must have held qualified shares for at least five consecutive years.

Second, governments should open more public infrastructure to institutional investment. Much of Canada's private equity investors seeking to invest in infrastructure have to look abroad more than they normally would, due to lack of opportunities in Canada.

Third, the preferential lower tax rate for small business should be targeted at young and growing businesses, in contrast to applying it to all businesses that are small. The idea in doing so is to encourage rather than dis-incentivize growth.

Such measures, and others that might focus on growing companies and on opening doors to Canadian investments within Canada itself, would leverage the already positive role that private equity investments play in supporting Canada's economic growth.

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