

FROM GOOD TO GREAT: NURTURING SMALL BUSINESS

GROWTH IN BRITISH COLUMBIA

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**Prepared for the SFU School of Public Policy
and the BC Population Prosperity Initiative**

February 2013

The role of small businesses necessarily features prominently in any discussion of the structure and performance of British Columbia's economy. Indeed, it is no exaggeration to say that an orientation toward small businesses is a defining characteristic of the province's private sector. In some respects the same can be said of Canada as a whole: as a jurisdiction, Canada is known as a friendly place for business start-ups and early stage entrepreneurial activity, a point emphasized in numerous international surveys and analytical reports.² It is also the case that compared to some other advanced economies, in Canada small firms account for relatively large shares of all businesses and of private sector output and employment.

This paper is concerned with small businesses in British Columbia – and more specifically, with the importance of fostering growth among such enterprises as an explicit goal of public policy. The focus on growth reflects the reality that the expansion of business production and payrolls is far from being the norm for small companies. In fact, the vast majority of small businesses don't grow, and relatively few ever graduate to the point where they become medium-sized or "big" companies. In addition, there is a high mortality rate among start-up businesses: in Canada, around half disappear within five years of establishment.³

Overall, the small enterprise sector in BC – as in the country as a whole – is dynamic, highly competitive, and populated by many hard-working owner-operators. One result of

¹ The views expressed in this paper are the author's alone.

² World Bank, Doing Business 2010: Reforming Through Difficult Times (2010). Available at www.doingbusiness.org; Alexandra Bibbee, "Unleashing Business Innovation in Canada," OECD Economics Department Working Papers No. 997, October 2012.

³ Industry Canada, Key Small Business Statistics, July 2012, p. 14; www.ic.gc.ca/sbststatistics

this is widespread churn, as many firms enter and exit the marketplace every year. In Canada, approximately 100,000 new businesses were created every year between 2002 and 2008, while “exits” averaged about 90,000 per year.⁴ In each case, British Columbia supplied 12-13% of the national totals. From 2008 to 2011, the number of small firms operating in BC edged up by only 1%, which was below the national average but higher than in the other Western provinces. With so many entries and exits, the small business sector exhibits a great deal of job creation – but this is accompanied by a similar amount of job destruction.

A Snapshot of Small Businesses in BC

The most recent Small Business Profile,⁵ an annual publication co-produced by BC Stats and Western Economic Diversification Canada, provides information on the number and distribution of businesses in the province. In developing the report, the government agencies define “small businesses” as all enterprises with fewer than 50 paid employees; they also include the self-employed – both unincorporated and incorporated – who operate their businesses with no paid help. Firms with 50 or more paid workers are classified as “large” enterprises in the Small Business Profile report.

Parenthetically, it should be noted that the Canadian government and many non-governmental researchers use different cut-off points for firm size. Federal government reports typically define small businesses as having fewer than 100 paid employees, while medium-sized firms are those with 100-499 employees and large ones have 500 or more.⁶ Treatment of the self-employed – including the extent to which they are counted as small businesses – varies in the studies produced by government agencies and academic researchers. Some Industry Canada and Business Development Bank of Canada reports calibrate firm size on the basis of annual revenues, exports, or even balance sheet indicators, rather than number of employees. Other developed countries and international

⁴ Ibid., p. 12.

⁵ BC Stats and Western Economic Diversification Canada, Small Business Profile, 2012. Available from www.gov.bc.ca/sted

⁶ See for example Industry Canada, Key Small Business Statistics, July 2012; www.ic.gc.ca/sbstatistics. Some federal government reports and analytical papers exclude self-employed businesses with no paid employees from the category of small businesses. That is not the approach taken by the BC government or its statistical agency, BC Stats. British Columbia generally counts the self-employed as small businesses regardless of whether they have any paid workers, perhaps because the self-employed are so numerous in the province.

economic agencies have adopted their own frameworks for categorizing business enterprises by size. All of this can make cross-national comparisons somewhat challenging.

Table 1 summarizes a few top-line findings of the latest BC Small Business Profile report. In 2011, there were 391,500 businesses registered in British Columbia, of which 98% had fewer than 50 employees and thus were classified as

“small.” A substantial majority of these are actually self-employed operators/ proprietors with no paid workers. Fully 82% of small businesses have fewer than five employees – these are often referred to as “micro” businesses. About 12,700 firms in the province employ between 20 and 49 workers.

Of interest, in 2011 only 6,400 enterprises in British Columbia directly employed 50 or more people; this is down from 7,000 in 2008. Firms with 50 or more employees can be further divided into “medium-sized” and “large” enterprises. More than 80% of the businesses falling into these two categories combined have between 50 and 250 workers. The Business Council of BC estimates that only 700-800 private sector enterprises in the province have more than 500 employees on their direct payrolls.

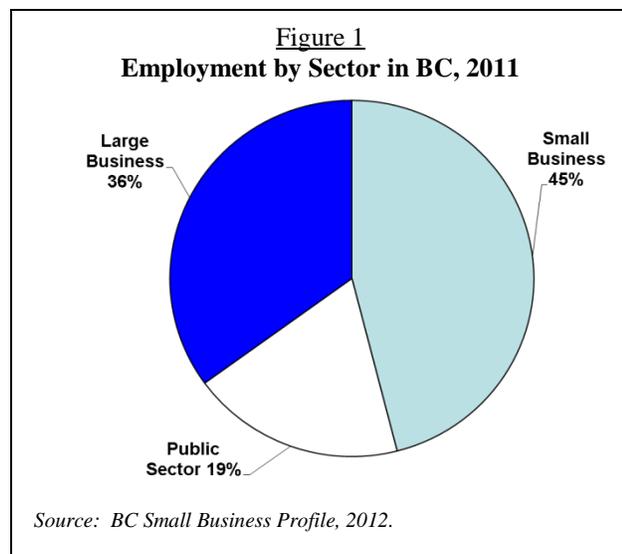
Figure 1 shows the distribution of employment in the province as of 2011. Enterprises with 50 or more employees (“large businesses” as defined by the Small Business Profile report) were responsible for 36% of all jobs, small businesses (including the self-employed) for 45%, and the public sector for about

Table 1
Breakdown of Businesses in British Columbia, 2011

	Number of <u>Businesses</u>	Per cent <u>of Total</u>
Total small businesses	385,100	98%
Self-employed without paid help*	217,900	55%
Businesses with less than 50 employees	167,200	43%
Total large businesses	6,400	2%
Total all businesses	391,500	100%

* Incorporated self-employed are not included in this figure in order to avoid double-counting, since they are already included in the count of businesses with fewer than 50 employees.

Source: BC Stats using data supplied by Statistics Canada.



one-fifth of the total. Some 1.85 million British Columbians earn their livelihood in the broadly defined private sector. “Large” enterprises (50 or more paid workers) directly support 44% of these private sector jobs, while small businesses with paid employees are responsible for one-third. Remarkably, almost 23% of private sector jobs in BC (18.5% of all jobs) are supplied by self-employed individuals without paid help. Overall, BC has the highest share of self-employment in Canada, three percentage points above the national average in 2011.⁷ Some of those classified as self-employed without paid help are “professionals” – e.g., lawyers, accountants, physicians, dentists, veterinarians, financial planners – while many others run tiny (often home-based) businesses in areas like home cleaning, home renovation, appliance and electronic repair, consulting, export-import, landscaping, hairdressing, etc. Many artists, writers, researchers, and child care providers are also found among the burgeoning ranks of BC’s self-employed. By industry, small businesses with no paid employees are particularly common in business services, construction, health/social services, and finance.

Here is an interesting data point about the composition of self-employment in British Columbia: over the past decade, the number of business operators with paid help grew only one-third as fast as the number with no paid employees (9.2% versus 26.5%). This highlights what, arguably, is a structural weakness in the province’s economy. A substantial amount of reported employment growth is occurring in one-person “businesses,” most of which aren’t likely to expand (if they survive). An unknown but probably sizable portion of this growth reflects an actual or perceived lack of suitable paid employment opportunities for the nascent “entrepreneurs.” This trend may have wider economic consequences: because the self-employed, on average, earn less than paid employees, sustained growth in the number of self-employed is apt to exert a dampening effect on household income (even though quite a few self-employed do enjoy high incomes).

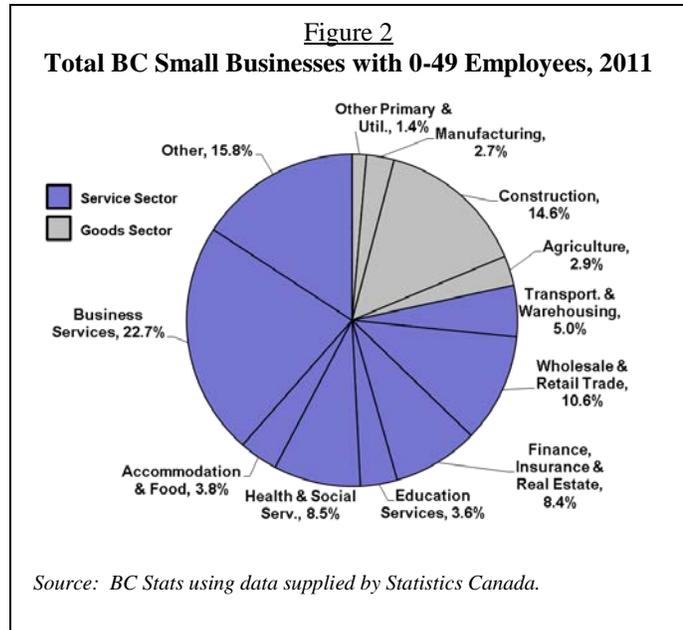
Looking just at firms with paid workers, it turns out that medium- and large-sized companies (50 or more workers) together employ significantly more British Columbians (821,500 as of 2011) than do their smaller counterparts (606,400). The proportion of total employment in the small business sector has fallen since the 2008-09 recession.⁸ Thus, the frequently-cited

⁷ Small Business Profile, p. 11.

⁸ Ibid., p. 9.

claim that micro and other small businesses are responsible for most private sector jobs and for almost all net job creation is incorrect. Particularly in a growing economy, all size categories of businesses tend to be adding jobs over time.

Figure 2 shows the distribution of BC small businesses⁹ by industry sector. Not surprisingly, business services, retail/wholesale trade, health care, and



finance/insurance/real estate have many tens of thousands of small enterprises – some with paid workers, others without. So does construction, which reflects the presence of numerous small contractors and sub-contractors engaged in home construction and renovation. Smaller firms are less common in manufacturing, utilities, and most primary industries

Small Business, Fast-Growing Firms, and Employment

In the United States, the pioneering work of Birch and his collaborators in the 1980s and early 1990s cast a spotlight on the central role of the fastest-growing firms – “gazelles” was the term he used – in driving job creation.¹⁰ Recent research strongly reinforces this finding. A detailed study by the Kauffman Foundation estimates that, in a typical year, the top-performing 5% of all American businesses – measured by their rate of employment growth – generate two-thirds of new jobs in the economy. And the top 1% of firms is responsible for an astonishing 40% of net job creation.¹¹ Thus, a relative handful of US companies account for a markedly disproportionate share of employment growth at the economy-wide level.

⁹ Including self-employed owner operators.

¹⁰ D. Birch, “Change, Innovation and Job Generation,” *Journal of Labor Research*, volume 10, number 1 (1989), pp. 33-39; D. Birch and J. Medoff, “Gazelles,” in L.C. Solomon and A. R. Levenson, eds., *Labor Markets, Employment Policy and Job Creation*, Westview Press, 1994.

¹¹ Dane Stangler, *High Growth Firms and the Future of the American Economy*, Kauffman Foundation Research Series: Firm Formation and Economic Growth (March 2010). Available from: www.kauffman.org

Most businesses in the top 5% and top 1% categories tend to be quite young – less than ten years old – and are small or medium-sized, as defined by US statistical agencies.¹² The picture that emerges from the Kauffman-sponsored research is that, over a period stretching from 3-4 years to a decade or so, a few thousand US companies grow from small to reach substantial size, with the top tier of these firms eventually employing 2,000-10,000 people each. As the Kauffman study observes: “These super high-growth [companies] become *scale firms*, the next generation of iconic companies.”¹³

Turning to Canada, a recent paper published by Industry Canada explored the issue of fast-growing firms in a national context. The authors determined that 4% of all Canadian businesses could be categorized as “high growth,” as measured by their increases in employment. Specifically, such firms had to be adding jobs by at least 20% a year over a three-year period to be defined as high-growth. Only 0.5%-1.0% of Canadian firms grew fast enough to qualify as “gazelles.”¹⁴

Rapidly growing businesses are critical to private sector job creation in Canada, as they are in the United States, but Industry Canada researchers have not had access to data comparable to that used in the Kauffman Foundation report referenced above. Recent Industry Canada publications do, however, cast doubt on the notion that small businesses are always and everywhere the predominant source of employment growth. For example, looking at Canada over the years 2001-2011, large enterprises (500 plus employees) as a group created more jobs than either small or medium-sized firms from 2003 to 2008; small firms led the way in 2001-2002, and again in 2010.¹⁵ Over the entire period, small companies supplied 43% of new private sector jobs. The vast majority of Canadian small businesses did not create any new jobs – and a sizable number shed jobs or closed down – over the period examined.

¹² In the US, small businesses are generally classified as those with fewer than 250 employees; medium-sized as those with 250-500 employees; and large firms as those with more than 500 paid workers.

¹³ Stangler, High Growth Firms and the Future of the American Economy, p. 6; emphasis added.

¹⁴ Industry Canada, The State of Entrepreneurship in Canada (February 2010). Report compiled for Industry Canada by Eileen Fisher and Rebecca Reuber. Available from: www.ic.gc.ca/research

¹⁵ Industry Canada, Key Small Business Statistics, July 2012, pp. 21-22. Employment fell across all business size groups in the recession year of 2009.

Recent research on entrepreneurship by the Organization for Economic Cooperation and Development comes to similar conclusions. According to the OECD's Entrepreneurship at a Glance report, somewhere between 3.5% and 6.0% of the total population of business firms in the advanced economies count as "high-growth enterprises," defined as having posted average annual employment growth of 20% over three years. (Using a different criterion, sales growth, the proportion of high-growth enterprises is slightly higher.) The OECD treats "gazelles" as a sub-set of these high-growth businesses, basing its definition on whether the firms were born five years or less before the observation period and had at least ten employees at the beginning of the period. In most advanced economies, less than 1% of all firms are "gazelles," according to the OECD.¹⁶ This aligns with the conclusion of the Industry Canada study referenced in footnote 14.

Unfortunately, there is little data on individual provinces that is comparable to the information in the Kauffman Foundation or Industry Canada studies, so we don't have a very good window into underlying employment dynamics by firm size in British Columbia. The annual Small Business Profile does track change in the number of businesses by industry and by region, but the data are quite limited, and the report makes no attempt to isolate the net employment (or other economic) contributions of the relatively tiny subset of rapidly expanding BC firms.

It's Not Just About Jobs

While media reports and government news releases commenting on small business issues tend to focus on jobs, the economic impact of smaller enterprises extends well beyond the labour market. This section touches briefly on several other measures that help to illuminate the economic contributions of both small enterprises and businesses in general.

GDP/Value Added

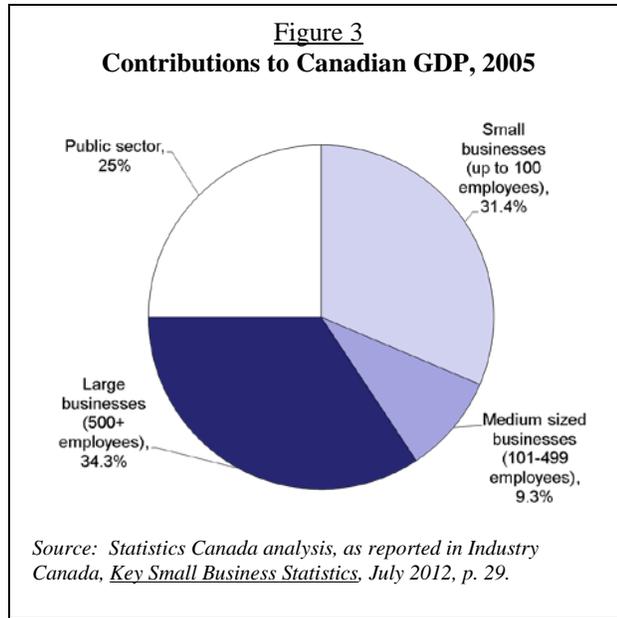
In BC, businesses with 0-49 paid workers accounted for 29% of output or real gross domestic product (GDP) in 2011. This is slightly higher than the figure for Canada (27%).¹⁷ Saskatchewan and PEI are the two provinces in which small businesses produce the largest shares of output. Using a somewhat different definition of small businesses –

¹⁶ OECD, Entrepreneurship: at a Glance 2012, http://dx.doi.org/10.1787/entrepreneur_aag-2012/en

¹⁷ Small Business Profile 2012, p. 3.

firms with 1 to 100 paid employees – Industry Canada estimates that such enterprises collectively were responsible for 31% of Canada’s GDP a few years ago (see Figure 3).

Data assembled by the OECD indicate that in most advanced economies, larger firms – specifically those with 250 or more employees – produce 40-56% of private sector “value-added,” which is the difference between the value of



firms’ output and their consumption of intermediate inputs. Across the higher-income OECD countries, there is also considerable variation in the proportions of value-added attributable to small businesses (fewer than 50 employees): from 22% in Japan to 31-32% in Germany and the UK, to more than 40% in Spain, France and Belgium.¹⁸

On a per worker basis, value-added tends to climb in tandem with number of employees in a business establishment, meaning that workers are often more productive when they are associated with larger enterprises. There are several reasons for this. One is that such firms generally have better educated and more highly skilled workforces. Another is that bigger enterprises typically exhibit a higher average ratio of capital per employee compared to micro- and other smaller firms. Other factors that may boost value-added per employee as firm size expands include longer production runs (allowing fixed costs to be spread over more output), increased specialization of tasks, a greater propensity to sell outside of local markets, readier access to sources of finance, and better qualified managers.¹⁹

Wages/benefits

Because there is a positive relationship between both value-added per employee and labour productivity, on the one hand, and plant or establishment size, on the other, it should come as no surprise that, on average, a similar relationship exists between firm size and worker

¹⁸ OECD, *Entrepreneurship; at a Glance 2012*, http://dx.doi.org/10/1787/entrepreneur_aag-2012/en

¹⁹ Institute for Competitiveness and Productivity, *Small Business, Entrepreneurship and Innovation*, Working Paper 15, February 2012; www.competeprosp.ca

compensation. National-level data collected by Industry Canada and summarized in Table 2 show that employees of businesses with fewer than 50 and 100 workers had weekly earnings below the economy-wide average of \$852 in 2011; earnings are also below the average for some employees at firms categorized as medium-sized. In contrast, employees of larger enterprises receive compensation that is comfortably above the private sector average.²⁰

Apart from better wages/salaries, larger

enterprises are also more likely to provide access to retirement, extended health, and other employment-related benefits that may significantly increase overall employee compensation. Most small businesses – understandably – have neither the financial nor the organizational capacity to offer more than quite modest non-wage benefits (beyond what is required by law).²¹

Does the broad Canadian compensation picture sketched above apply to British Columbia? Yes: “On average, small businesses tend to pay their employees lower wages compared to larger businesses.”²² These lower wages, in turn, produce smaller annual earnings. In 2011, the average full-time equivalent small business worker in BC pulled down an annual salary of \$38,811, compared to \$46,594 for employees of “larger” businesses (50 or more workers).²³ Unfortunately, the BC-specific data don’t permit a more refined breakdown of earnings by firm size (e.g., 1 to 4 employees, 50 to 250 employees, 500 plus employees, etc.). But based on the national data, it seems reasonable to assume that annual earnings and employee benefits will tend to be better at the biggest companies – i.e., those employing 500 or more workers – although this is by no means a hard-and-fast rule.²⁴ The

Table 2
Average Weekly Earnings by Firm Size,
Canadian Private Sector, 2011

Number of Employees	Earnings
0-4	\$789
5-19	\$727
20-49	\$771
50-99	\$793
All “small” firms (avg)	\$763
100-299	\$865
300-499	\$742
All medium sized	\$832
500 or more	\$941

Source: Industry Canada, Key Small Business Facts, July 2012.

²⁰ Industry Canada, Key Small Business Statistics, July 2012, pp. 25-6.

²¹ That said, some small firms may compensate for lower pay/benefits by providing more flexible work-time arrangements, greater employee learning opportunities, and/or a higher quality work environment.

²² Small Business Profile, 2012, p. 17.

²³ It is unclear from the report whether the annual earnings figures are adjusted to reflect possible differences in average hours worked in small compared to large firms.

²⁴ In particular, many small and medium-sized enterprises in the broad professional, scientific and technical services sector pay their employees well and rank near the top among all industries in average employee compensation.

fact that union density is well above the all-industry average among large firms and is low (and falling) in the province's small business sector also influences the observed compensation patterns.²⁵

Exports

Cross-national research confirms that as businesses expand, they become more likely to engage in international commercial activity, including exporting. In most advanced economies, at least half of total exports come from enterprises with at least 250 employees.²⁶ In some countries the biggest firms – 500 plus employees – dominate the national export statistics. Canada follows the general OECD pattern in terms of the export orientation of businesses of differing sizes. In 2010, 86% of active Canadian exporters had fewer than 100 employees, and they were responsible for almost one-quarter of the value of the country's exports of goods in that year.²⁷ Of this amount, the bulk of the export sales were made by firms with more than 50 employees.

Of interest, the data for British Columbia are only partially consistent with the national story. In 2010, about 6,000 BC companies were engaged in export trade. Some 84% of these firms had fewer than 50 workers. But these small businesses produced more than half of the province's merchandise exports in that year.²⁸ It should be noted that depressed market prices for lumber, natural gas and some other BC export commodities in 2010 may temporarily have inflated the share of small business exports in the provincial total, since large companies account for the bulk of natural gas and lumber export sales. Even so, it can safely be said that enterprises with fewer than 50 employees make a bigger contribution to BC's international exports than is the case for Canada as a whole.

British Columbia's small business exporters collectively employed 54,000 workers in 2010, which amounts to only 5% of all jobs in the small business/self-employment categories combined. This underscores the fact that exporting is a specialized and fairly unusual activity for small firms. Many small exporters are manufacturers, an industry that

²⁵ See the Business Council's bi-monthly Industrial Relations Bulletin for further discussion.

²⁶ OECD, "Selling to Foreign Markets: A Portrait of OECD Exporters," Statistics Brief No. 16, 2011; www.oecd.org/dataoecd/28/27/47014723/pdf.

²⁷ Industry Canada, Canadian Small Business Exporters, Special Edition: Key Small Business Statistics, June 2011.

²⁸ Small Business Profile, 2012, p. 29.

has a much greater export propensity than other sectors of the economy. But BC small business exporters are also found in agriculture, mining and other sectors.²⁹ The substantial contribution of smaller firms to BC's export mix is a positive sign, one that suggests there is considerable scope to further increase the involvement of locally-based SMEs in international markets.

Innovation

The accelerating pace of scientific and technical change is one of the most fundamental trends shaping the economic landscape. From health care to manufacturing to environmental goods and services, the development and application of new knowledge – often generated by science and technology – is redefining the way business is done. This has profound implications for the ability of countries and regions to prosper. Science and technology are closely linked to innovation. Innovation involves new or better ways of doing things that have economic value. New ideas and technologies that stay in the lab may increase the stock of human knowledge, but only when they migrate to the commercial world do they lead to significant economic benefits.³⁰

Innovation in a business context can be thought of as activities that fall under the following umbrella:³¹

- Product innovation – developing and bringing to market new/improved products.
- Process innovation – making changes in the way goods/services are produced or delivered to customers, typically by using more sophisticated technologies.
- Direct firm investments in research, product development, and the acquisition of capital goods, technologies and software that embody advanced knowledge.
- “Soft” innovations – changes in management and organizational practices and functions that lead to improvements in productivity, quality and customer service, or that build/strengthen linkages with relevant business clusters and external sources of expertise.

²⁹ Note that the export data cited here do not include interprovincial trade or international exports of services.

³⁰ Expert Panel on Business Innovation, Council of Canadian Academies, Innovation and Business Strategy: Why Canada Falls Short, Summary Report, April 2009, p. 7.

³¹ Organization for Economic Cooperation and Development, Oslo Manual, 2005.

British Columbia has a mixed record on most available measures of innovation. The BC Progress Board reports that over the 2006-2008 period, the province ranked 4th or 5th in Canada in R&D spending as a share of GDP. Total outlays on R&D edged up from less than 1% of GDP in 1990 to a still modest 1.4% by 2008.³² Business investment in R&D is very low, a finding that may be linked to the province's industrial structure (weighted toward resource extraction and domestically oriented service industries). Federal and provincial government support for front-end pre-commercial research, including in universities and teaching hospitals, has increased over time, but the fact remains that relatively few businesses in BC – large or small – are involved in any R&D-related activity.

For most BC enterprises, including small businesses, innovation has nothing to do with direct expenditures on research and development or patent activity. Instead, it means acquiring/using machinery, equipment, software and other assets that embody advanced technological knowledge; deploying novel marketing, customer relationship or supply chain strategies; and adopting human resource and other organizational practices that enable gains in productivity, efficiency and market share. Leaving aside R&D and patenting, BC seems to lag in several other areas related to innovation: overall private sector non-residential investment, business investment in machinery and equipment, and the share of scientists and engineers in the workforce.³³ The province also trails the country in post-secondary education completion among the locally-based population (this ignores the role of in-migration, which historically has augmented the supply of BC workers with post-secondary credentials). As recently noted by the major BC research universities, the province has a comparatively poor record of investing in graduate-level university programs and related research and student support – an area that is important to innovation.³⁴

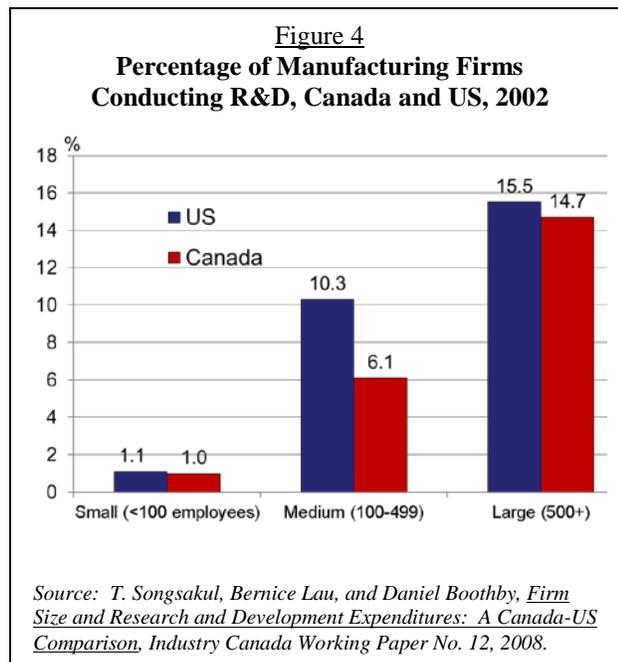
³² BC Progress Board, Final Benchmarking Report, December 2011.

³³ Ibid. Also see Andrew Sharpe et al, Productivity Drivers in British Columbia: Strategic Areas for Improvement, study prepared for the BC Progress Board, December 2008.

³⁴ The Research Universities Council of British Columbia, "Opportunity Agenda for BC," 2012.

The prevailing small business character of the province's private sector contributes to its somewhat lackluster innovation record. Contrary to what many believe, the presence of larger companies is positively correlated with innovation. Some 90% of worldwide business R&D is performed by companies with more than 250 employees, and close to 80% is done by those with 500 or more.³⁵ In Canada, 75 companies perform half of all private sector R&D.³⁶ Figure 4 shows the proportions of all US and Canadian manufacturers conducting R&D by size of firm, as of the early 2000s. Only a minuscule share of smaller companies are involved in any kind of R&D activity, even among manufacturers.

The reality is that bigger companies have a greater capacity to finance innovation, to commercialize new ideas, to forge and sustain alliances, to hire and develop engineers and scientists, to



deploy new process technologies, to draw benefits from participating in industry clusters, and to be part of collaborative arrangements with universities and external research and commercialization organizations. A significant weakness of the BC economy, as noted above, is that the province has only 6,400 firms with more than 50 employees, out of a total of 391,500 businesses. The typical technology company in BC has fewer than ten employees, with only a handful of firms in the sector employing more than 500. Far from being a strength, the paucity of larger innovative enterprises is an impediment to building globally competitive industry clusters in British Columbia -- and to fostering a more innovative economy generally.

³⁵ Organization for Economic Cooperation and Development, OECD Industry, Science and Technology Scoreboard, 2007.

³⁶ Alexandra Bibbee, "Unleashing Business Innovation in Canada," OECD Economics Department Working Papers No. 997, October 2012, p. 31.

Policy Implications

An interesting question is whether fast-growth firms develop essentially on a random or accidental basis, depending perhaps on the distribution of entrepreneurial talent and ambition across the private sector, or whether they are more likely to emerge in particular regions or at times of disruptive change. There are conflicting views on this among researchers. But the good news is that it is possible to set policy directions which can help to establish conditions in which growth-oriented enterprises and ambitious entrepreneurs are more likely to flourish.

Taxation

In this regard, one area that warrants some re-thinking is tax policy. Canada's business tax structure features significantly lower statutory rates and effective tax burdens on "small business" income (see Table 3 for details). In British Columbia, the government has adopted a low 2.5% tax rate for small

General federal corporate tax rate	15.0%
Small business federal tax rate (up to \$500,000)	11.0%
BC general corporate tax rate	10.0%
BC small business tax rate (up to \$500,000)	2.5%
Federal/BC combined general corporate rate	25.0%
Federal/BC combined small business rate	13.5%

Source: KPMG Tax Facts 2012-2013.

business, versus a rate of 10% for income earned by medium-sized and larger firms.³⁷ Federal statutory income tax rates are also higher for medium-sized and large firms than for smaller ones. The result is that the applicable income tax rate jumps sharply (almost doubling) once a BC firm has an annual income in excess of \$500,000. Some analysts refer to this as a "taxation wall" that may slow business growth and prompt some enterprises to reorganize their activities in order to retain access to preferential small business tax rates.³⁸

Several provinces have adopted payroll taxes to help fund health care or to raise revenue for general purposes. At present Ontario, Manitoba, Newfoundland and Quebec have broadly-based payroll taxes in place. Three of these provinces exempt some portion of payroll from tax, thus benefitting the smallest firms, while Quebec levies a higher payroll

³⁷ BC Budget 2012, table A-2, p. 128.

³⁸ Duanje Chen and Jack Mintz, "Small Business Taxation: Revamping Incentives to Encourage Growth," University of Calgary School of Public Policy, SPP Research Papers, Volume 4, Issue 7, May 2011.

tax rate on medium-sized and large employers.³⁹ Ontario exempts the first \$400,000 of payroll from its 1.95% Employer Health Tax. Moreover, Ontario employers with annual payrolls below \$600,000 are permitted to make a lump-sum annual payment instead of being required to remit in monthly installments. While well-intentioned, such exemptions and special rules have no compelling economic policy justification and undoubtedly encourage some small enterprises to avoid adding staff. This is another instance where tax policy may subtly retard business growth and send a message to enterprise owners/manager that it is better to remain small. British Columbia does not currently have a broad payroll tax, but if a future government ever decides to consider the idea it would be wise to steer clear of the exemptions found in Ontario and some other provinces.

At the national level and in most provinces, tax support for private sector research and development is also linked to firm size. Specifically, under the federal government's scientific research and experimental development (SRED) tax regime, small Canadian-controlled private corporations (CCPCs) making qualified R&D-related expenditures are eligible for a higher tax credit than other types of firms, including all larger companies. In addition, for CCPCs the tax credits are refundable up to certain limits, whereas for other businesses the tax credits are non-refundable. Most provinces, including British Columbia, effectively "top up" the federal R&D tax credits with their own variants (see Table 4 for details). With higher tax subsidies for R&D by small firms, the required rate of return for projects declines; this means the economic value of R&D projects may diminish as the subsidy increases.

There is some policy rationale for an enhanced refundable R&D tax credit scheme aimed at small innovative firms, given the difficulties these companies can encounter in securing external financing and the positive externalities that are believed to result from private sector research and development activity. However, evaluations of the existing tax credit program point to a number of problems, including high administrative and overhead costs, poor targeting of tax support, distortions caused by high effective taxes on earnings above qualifying threshold levels, and widely varying effective tax subsidy rates across sectors

³⁹ The exception is Quebec. See KPMG Tax Facts 2012-2013, pp. 128-9.

and between small and large firms.⁴⁰ The overall outcomes of the SRED program are also underwhelming when judged against the amount of R&D actually undertaken by businesses in Canada. Of particular relevance to this paper, the design of the federal and provincial R&D tax credit programs poses another tax-related barrier to enterprise growth.

In the 2012 budget, the federal government introduced important changes to its business innovation programs, including the SRED tax credits. While Ottawa's decision to reduce the generosity of tax credits for business R&D and to re-direct more resources into areas involving direct support for innovation may be justified, the modifications to the SRED program will compound the bias in favour of smaller firms and make it less attractive for larger enterprises to pursue R&D in Canada.⁴¹

Table 4
Federal and Provincial Tax Credits Rates for R&D

<u>Provinces</u>	<u>Provincial tax credit</u>	<u>Federal plus provincial¹</u>	
		<u>Small CCPCs</u>	<u>Other firms</u>
Alberta and British Columbia	10	42	28
Manitoba	20	48	36
New Brunswick, Newfoundland and Labrador, Nova Scotia, Saskatchewan and Yukon	15	45	32
Ontario (small/large firms)	10/4.5	42	24
Quebec (small/large firms) ²	37.5/17.5	48	27

¹The federal credit is 35% for small CCPCs (Canadian-controlled private corporations) and 20% for other firms. The base for the federal credit is reduced by the amount of provincial credits.

²The Quebec credit is paid on wages and salaries plus 50% of contracts. The federal-provincial rate is expressed as a percentage of R&D costs eligible for the SR&ED credit.

Source: Independent Panel on Review of Federal Support to Research and Development – Expert Panel Report, Innovation Canada: A Call to Action, Ottawa, 2011.

In all of the above areas, my recommendation is to shift tax policy in a direction that will incent enterprise growth and make the overall business tax system more “neutral” as between smaller and larger firms. While this may be a difficult choice for elected representatives, it is the right way to proceed in economic policy terms. For British Columbia, steps consistent with this recommendation could include reducing the basic

⁴⁰ Bibbee, “Unleashing Business Innovation in Canada,” pp. 28-32; Mark Parsons and Nicholas Phillips, “An Evaluation of the Federal Tax Credit for Scientific Research and Experimental Development,” Department of Finance Working Paper, 2007; Kenneth McKenzie, “The Big and Small of Tax Support for R&D in Canada,” University of Calgary School of Public Policy, SPP Research Papers, Volume 5, Issue 22, July 2012.

⁴¹ See Bibbee, “Unleashing Business Innovation in Canada,” and McKenzie, “The Big and Small of Tax Support for R&D in Canada.”

corporate income tax rate, nudging current preferential small business tax rates higher over time, or introducing new tax incentives directed at firms that grow by modernizing or expanding their capital stock (such as investment tax credits for machinery, equipment, advanced process technologies, new/upgraded manufacturing plants, etc.). One Ontario-based think tank recently suggested that the government consider reducing or eliminating tax on income in excess of that earned during the prior year for companies able to demonstrate that they are investing more in their business (in people, plant, equipment, or working capital).⁴² This idea merits consideration. Finally, absent action by the federal government, BC should also examine ways to mitigate the potentially growth-inhibiting features of its R&D tax incentive programs.

Other policy areas

The province could also review other areas of policy and public sector activity to see whether changes might be made to support growth-oriented BC firms.

- *Procurement.* In its review of federal programs for R&D and business innovation, the Jenkins panel identified government procurement as an important way to assist innovative Canadian firms to gain market traction.⁴³ Local market access, including markets where public sector institutions possess strong buying power, can allow innovative BC companies to build a domestic track record and thus improve their chances of achieving export success. The ability of BC firms to develop and export sophisticated goods/services is enhanced if they are able to meet the needs of demanding local buyers.
- *Cluster development:* Michael Porter and many other academic researchers contend that regionally-based industry clusters play a critical role in enabling growth and entrepreneurial success in sectors ranging from high technology and advanced manufacturing to finance, shipping, and design. Governments have no capacity to create successful clusters. But they can facilitate industrial development by supporting organizations committed to cluster growth and the commercialization of locally-developed innovation. One BC example is Wavefront, an organization that

⁴²Institute for Competitiveness and Prosperity, *Small Business, Entrepreneurship and Innovation*, p. 54.

⁴³Independent Panel on Federal Support to Research and Development, *Innovation Canada: A Call to Action*, 2011, chapter 7.

supports the wireless technology sector in the lower mainland. As the predominant land owner in BC, the provincial government may be able to leverage its extensive land holdings to foster the development of regionally-based industry clusters.

- *Financing:* Start-up firms require financial resources to commence operations and to grow. There is evidence that some smaller firms in Canadian industry sectors characterized by high levels of innovation suffer from under-funding.⁴⁴ Expanding the supply of “angel” risk capital for early-stage companies can help to address this problem. Angel investment has been central to the development of many early-stage technology companies. British Columbia was the first province to establish a tax credit for small-scale angel investments targeted at companies requiring \$100,000 to \$2 million in capital. To date the resources committed to the program by the province stand at \$33 million. Other provinces have examined the BC program and some are considering something similar. While programs to bolster angel funding may assist early-stage businesses, they aren’t designed to improve access to financing for companies seeking to grow beyond a modest scale.

Conclusion

The small business world can be divided into two types of firms: a massive number of “main street” businesses that don’t grow much if at all but collectively employ many people and produce/sell a wide array of needed goods and services; and a much smaller number of entrepreneurial high-growth firms that expand rapidly and are important sources of job creation, productivity, exports, and innovation. “Main street” businesses are found in many sectors of the economy but are particularly ubiquitous in industries like retail, foodservices, car repair, construction, and personal and business services. They are a visible and important part of the business community, but they are far from being the whole story when it comes to business growth. As noted above, that’s partly because there is a high level of churn in sectors dominated by smaller firms. But it’s also because the owners/managers of many of these firms have no desire to expand, take on additional risk, or pursue new markets. This is not a criticism: it reflects the goals of, and the constraints facing, the individuals running most small businesses, as well as the inherently local nature of the markets that they typically serve.

⁴⁴ Institute for Competitiveness and Prosperity, Small Business, Entrepreneurship and Innovation, pp. 35-37.

A large body of research tells us that growth-oriented companies follow a different path. The founders of these firms are often crucial to their ongoing development. Importantly, fast-growing businesses are found in many industries – not just in high-technology, software, entertainment, etc. But the reality is that they represent only a small slice of the hundreds of thousands of businesses in our economy – certainly less than 5% of all firms with paid help in the case of British Columbia.

Government policy should pay greater attention to this subset of striving firms and look for ways to encourage and support entrepreneurs and enterprises that are ambitious to expand production, to export and to innovate. Public policy should be less concerned with promoting small businesses and self-employment in general, and more focused on enabling the success of the sub-set of entrepreneurial, high-growth, high-impact firms. As an eminent federal government advisory group recommended in 2008:

“Federal and provincial governments’ small and medium-sized enterprise policies should focus on those firms that demonstrate the desire and capacity to grow to become large enterprises.”⁴⁵

⁴⁵ Competition Policy Review Panel, Competing to Win, Final Report, June 2008, p. 75.