A paper prepared for the

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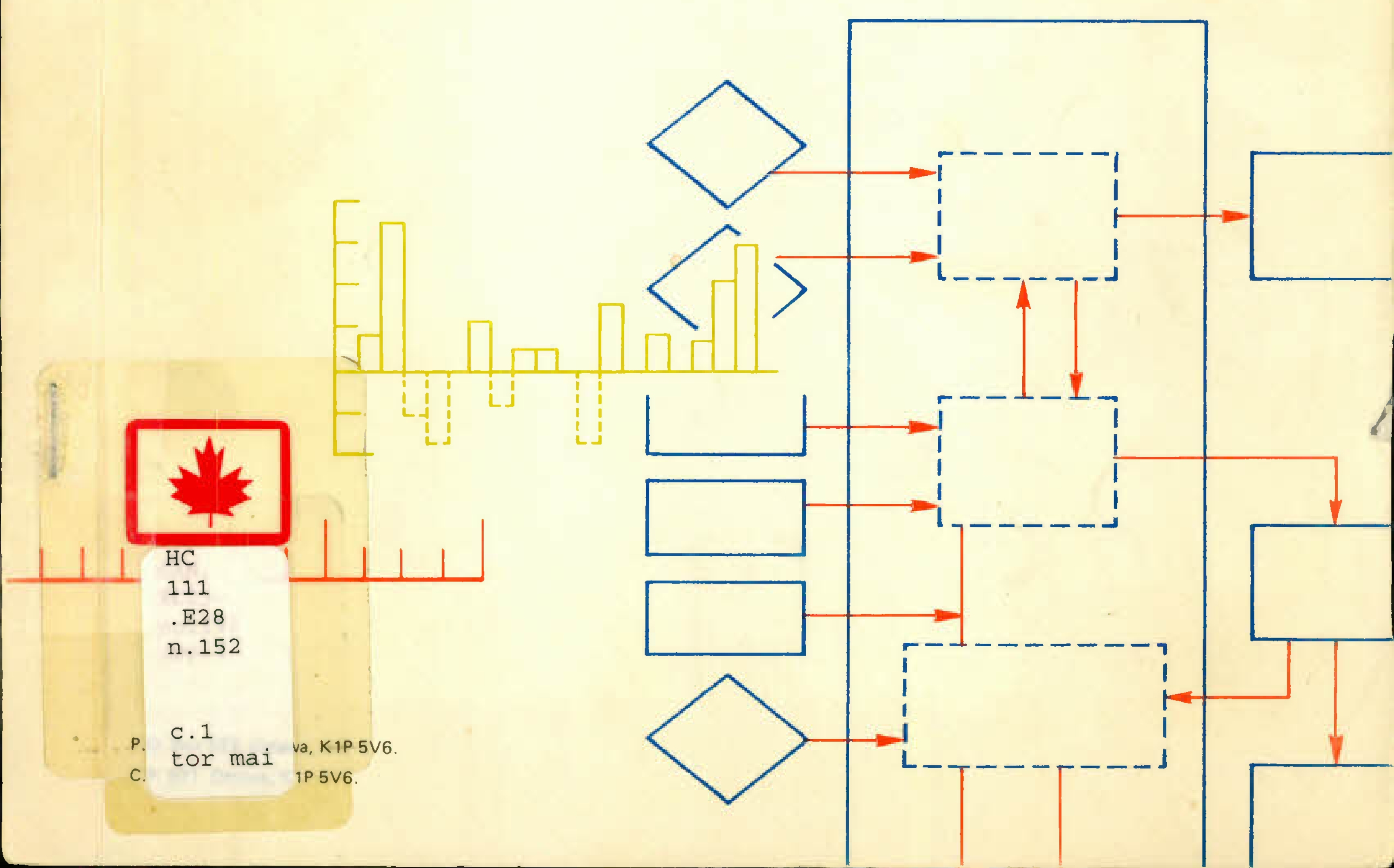

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DISCUSSION PAPER No. 152

Government Incentive Programs in Canada: Are They an Effective Tool in Stimulating Investment in Productive Plant and Equipment?

by Ernst & Whinney, Chartered Accountants

Background Paper to the Sixteenth Annual Review

The findings of this Discussion Paper are the personal responsibility of the author and, as such, have not been endorsed by members of the Economic Council of Canada.

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Table of Contents

PREFACE

This paper is not typical of the Discussion Paper series. It was not designed to meet our customary standards for rigorous theoretical empirical analysis. It is an impressionistic, if critical, survey of the experience of businessmen with government investment assistance programs, written by people who are intimately familiar with this experience.

In our view, there is a place for an essay of this type. Surely evidence available to date on effectiveness of incentive measures is not complete nor definitive. This essay offers rich institutional and behavioural detail that seems relevant to the design and delivery of assistance programs; additionally, many ideas advanced here may serve as working hypotheses in further empirical work. The best way to promote these applications obviously is to put this text out in the public domain in the hope that it will stimulate debate and research. The text is also useful as a thinking man's introduction to government assistance programs.

Dr. D. W. Slater
Acting-Chairman
Economic Council of Canada

RÉSUMÉ

Ce document présente une analyse de l'impact des programmes publics d'aide à l'investissement privé sur la décision d'investir. Les auteurs se placent du point de vue de l'entrepreneur dont la décision d'investir peut être influencée par des programmes gouvernementales de financement, taxation ou autre.

Après avoir énuméré plusieurs types de stimulants, l'étude passe à l'analyse détaillée de la décision d'investir. C'est ainsi qu'on nous décrit ce qui, selon l'entreprise considérée (petite ou grande, étrangère ou canadienne, etc.), peut inciter à investir ou au contraire y faire obstacle; l'analyse permet d'évaluer quel stimulant aura le plus de poids auprès d'une firme qui veut investir. Les auteurs en arrivent à la conclusion que la décision d'investir est rarement directement motivée par les stimulants. En conséquence, ceux-ci représentent la plupart du temps un gain supplémentaire inespéré.

Il arrive que les stimulants aient une influence sur le choix du lieu et de la date de l'investissement, mais généralement cette influence n'est pas radicale. Par contre, elle sera plus sensible, s'il s'agit d'un investissement de remplacement dont la date reste à définir, que s'il s'agit d'un investissement initial. Certaines sociétés pourront

accepter de quitter un centre urbain et s'implanter à la périphérie d'une zone économique, mais rarement de quitter la région. Il semble que dans ces cas (ou encore lorsqu'il s'agit de choisir entre le Canada et un autre pays), le rôle joué par les stimulants (financiers ou autres) ne soit pas ce qu'il devrait être, par rapport aux autres facteurs qui motivent la décision d'investir.

Il en découle qu'un stimulant sera d'autant plus efficace (c'est-à-dire qu'il provoquera l'investissement, ou des modifications non négligeables dans le choix du lieu et du moment) que sa part dans le calcul du projet sera plus importante. L'étude cite plusieurs cas de succès de programmes d'aide réussis. Par contre, la médiocrité de certains résultats est attribuée à toute une série de facteurs : les changements trop fréquents de programmes et de plans, leur trop courte durée, le manque de communication entre le gouvernement et le secteur privé et les lenteurs du processus législatif.

Dans un monde où les pouvoirs publics des différents pays rivalisent pour attirer chez eux les capitaux et l'offre de travail, le Canada n'a past le choix et se doit d'offrir un programme allêchant d'aide à l'investissement privé. Les justifications économiques et sociales de tels programmes ne manquent pas; le Canada doit persévérer dans cette voie et veiller à en améliorer l'efficacité.

ABSTRACT

This paper reviews how government incentives for business investment affect the investment decision. It does so from the perspective of the businessman facing concrete choices affected by availability of financial, tax and other government measures.

Following a sketch of various types of incentives, the text takes a close look at the investment decision. A number of motives for investing, and barriers to investment are offered. These are further explored in their importance to various types of firms -- large or small, foreign or Canadian owned, etc. -- which provides a context for assessing which type of incentive is most likely to have an effect on the decision whether to invest of a given firm. The general conclusion is that incentives rarely trigger the decision to invest. It follows that there is a large element of windfall gain in most incentives.

Timing or location of investment may be affected by incentives, but not, generally, in a drastic way. Replacement investment may be more readily influenced as regards timing than new investment. Firms may be induced to move from the central urban core to the periphery of an economic region; rarely would they move to another region altogether. In these cases as well as where

the choice is between locating in Canada or elsewhere it appears that individual financial or other incentives do not carry a large enough weight among the many factors influencing the decision.

Hence, for incentives to be effective (i.e., to induce investment or significant shifts in timing or location of investment) the incentive must be large in relation to total project cost. Examples of highly successful incentives are given. Frequent changes in programs and policies, the often short-term nature of incentives, lack of government-business communication, and time delays in passing legislation are seen to detract from the effectiveness of incentives.

In a world where governments compete to attract investment and jobs Canada has little choice but to maintain an attractive package of incentives. There are also a number of legitimate economic and social goals which governments may pursue by means of incentives. Canada must continue to offer incentives and aim at improving their effectiveness.

AUTHORS' PREFACE

It is likely that governments will continue to develop and operate investment incentive programs indefinitely into the future. Whatever the good intentions and economic reasoning about their objectives and their effects may be, the actual outcomes will depend critically on the attitude and ability of the business community and their advisors to use the programs. It is an essential ingredient of policy formulation and operation regarding incentive programs to consider the nature of responses of businessmen and their advisors. This is by no means the whole story of incentive programs but it is an essential ingredient.

Canada has by now many years of experience with a large and changing set of incentives. It is, therefore, worthwhile to put together the considered judgments of the business community on this experience as one element of contribution toward lessons for the future. This study, commissioned by the Economic Council of Canada, attempts to do just that.

Many studies or papers have been written to prove or disprove particular theories or to assess the impact of a particular program. One such government study was the Corporate Tax Measures Review Committee, which in 1974 issued a report suggesting that the manufacturing and processing incentives introduced in the Income Tax Act in 1973 had quite a beneficial impact. That study may have been partly responsible for the government's decision to make the 50 per cent fast writeoff for manufacturing and processing machinery a permanent measure in the Income Tax Act. Other studies done on certain aspects of this general question are numerous and tend to be rather inconclusive. It seems that subjectivity is unavoidable, even after extensive analysis of data and opinions.

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We have not attempted to substantiate the many opinions, observations and intuitions expressed in the paper with existing or new empirical evidence. There are sources to support conflicting viewpoints on many of the issues, and reliance on analytical studies without critical examination thereof may be self-serving and merely cloud the large degree of subjectivity inherent in any evaluation of government incentives. This paper is intended as an independent commentary on how businessmen in various circumstances react to different incentives.

We believe that the businessman's actions are dependent in important ways on psychological and other human factors, in addition to the customary financial factors. For this reason, any commentary on how incentives affect the actions of businessmen would have to be largely subjective even if much preliminary analytical work were conducted. We have tried to indicate where we feel our statements could be supported by further empirical study or whether they are intuitive comments that may or may not be supportable.

The principal focus of this study is to comment on whether or not government incentives are effective and, if so, the extent to which they encourage or alter investment decisions. It comments on the main types of incentives and describes how each type is viewed by Canadian businesses of different size and type.

The objective of this report is not to prove or disprove any particular theory about government incentives but merely to identify their strengths and weaknesses in altering patterns of investment in productive plant and equipment. Some facets deserve further study. For example, the cost of incentives, especially tax-oriented ones, is extremely difficult to measure, and this has rarely been attempted. It is not, however, our goal to do so here. The paper entitled "Government of Canada Tax Expenditure Account", which the Minister of Finance published with his December 11, 1979 budget was perhaps the first government effect to reveal the cost of tax concessions. It is also interesting to compare that publication with another recent one entitled "Tax Expenditures: An Examination of Tax Incentives and Tax Preferences in the Canadian Federal Income Tax System", published by the Canadian Tax Foundation. As might be expected, their cost estimates frequently differ. NB !!

Our basic conclusion is that government incentives in Canada do not for the most part trigger a decision to invest in plant and equipment, but that they may affect the execution of that decision, for example, by altering its timing and location. There are, of course, some incentives that have resulted in a decision to invest. A few of these more effective incentives, such as those for multiple unit residential buildings (MURBS), oil and gas drilling funds, Canadian films, income bonds, and term-preferred shares, are discussed.

1 Categories of Incentives

There is a vast array of incentives available to businesses in Canada today. In recent years, they have been changing at a very rapid pace. Although these incentives may be classified in many different ways, for purposes of discussion here they are grouped into three broad categories:

1. Direct financial assistance incentives including grants loans, government guaranteed loans, subsidies, and equity investments and joint ventures.
2. Tax incentives including fast writeoffs, writeoffs in excess of 100 per cent, investment tax credits, and reduced tax rates.
3. Non-financial, non-tax incentives or disincentives such as protective tariffs and quotas, competition from Crown corporations, government purchasing policies, and the Foreign Investment Review Agency.

The following brief discussion points to those features of each type of incentive that are likely to influence the businessman in some aspect of his investment decision. Information on the major programs in existence is presented in small type.

Direct Financial Assistance

Grants are available from several levels of government and may therefore involve a degree of overlapping. They are available only after extensive discussion with the relevant government authority. As a result, applicants must submit to a lengthy negotiating or screening process.

Grants frequently impose obligations upon the recipient to do things he would not otherwise do in the process of making his investment. They frequently require some monitoring by government for a number of years to ensure that the recipient continues to meet certain objectives, such as creating a specified number of jobs.

Grant assistance is frequently made at the beginning of a particular investment or event. At other times, the monies may be paid in stages, contingent upon the recipient's ability to meet some specified commitment, which lessens their usefulness as up-front financing. Nevertheless, they are the most financially attractive form of assistance because they do not have to be repaid if the recipient fulfils his obligations.

The federal government offers several grant programs under various agencies. The Department of Regional Economic Expansion (DREE) offers Regional Development Incentive grants to firms who qualify on the basis of the capital cost of capital assets and the number of jobs to be created in designated geographic locations. As in most government assistance programs, these grants cover both plant and equipment. The Indian and Northern Affairs Department supervises the Indian Economic Development Fund, which helps Indians establish and develop profitable businesses that can provide work for Indians. Grants available from the Canada Employment and Immigration Commission include the Canada Manpower Industrial Training Programs as well as assistance for Job Experience Training.

The Department of Industry, Trade and Commerce sponsors several grant plans. The Defence Industry Productivity Program (DIPP) provides grants for up to 50 per cent of costs for product development for export sales of defence industry companies. The Enterprise Development Program (EDP) aids in the development of new or improved products and processes. It also assists with market studies, productivity improvement studies, industrial design, and projects to identify new products. The Industrial Research Assistance Program (IRAP) pays salaries of individuals working on applied industrial research and development. The Department of Industry, Trade and Commerce also provides grants through the Program for Export Market Development and the Promotional Projects Program.

Among the provincial governments, the Newfoundland Department of Rural Development awards grants, based on the capital cost of capital assets and the number of jobs created, to small businesses unable to meet the size requirements of the federal DREE program. Saskatchewan provides grants towards the capital costs of tourist facilities, and to prevent bankruptcies or job losses.

Loans are generally of two types. They may be akin to private sector loans, or they may be in the nature of an incentive, with reduced interest rates or deferred repayment of the principal. Normally they involve as much of a screening or negotiating process as grants, and government bodies may impose as many extra obligations as in the case of grants, including special reporting requirements.

Loans usually must be repaid and are therefore financially less attractive than grants. If, however, the loan limits are much larger than those of grants, businessmen may attach as much or more importance to loans. If a government loan requires normal security, it competes with other outside third party loans, and this may have a bearing on the ability of the business to get additional outside financing from third parties at a later date.

Loans are available from the federal government through two main sources. The Federal Business Development Bank makes loans largely for the purchase of buildings, land, or equipment. Loans may also be used in some situations for working capital. They are generally available to small businesses of any type. The Farm Credit Corporation (FCC) makes loans for the purchase of land, breeding stock, and farm equipment. Loans may also be used for permanent improvements and refinancing.

As regards provincial government programs, the Alberta Opportunity Company makes loans to selected industries to finance assets and working capital. The majority of loans are under $500,000. Loans provided by the British Columbia Development Corporation have features similar to those of the Alberta Opportunity Company. The Manitoba Development Corporation offers loans with flexible terms to a broad range of businesses perceived as being beneficial to Manitoba. The New Brunswick Department of Commerce and Development makes loans basically just to manufacturing industries for assets and working capital. The Newfoundland Department of Rural Development offers interest-free loans to rural-based manufacturing, processing, and craft industries for assets and working capital. The Newfoundland and Labrador Development Corporation makes term loans for assets.

Loans from the Nova Scotia Resources Development Board are available to manufacturing, tourism, and fisheries industries for asset financing and refinancing. The several Ontario Development Corporations (ODC, EODC, and NODC) offer incentive loans and normal term loans for small businesses principally in manufacturing and tourism industries for industrial mortgages, leasebacks, and venture capital. Prince Edward Island Industrial Estates Incorporated makes loans for assets and, in some cases, working capital for tourism, manufacturing, and processing industries and for some manufacturing service companies. Loans from the Quebec Industrial Development Corporation are designated for assets and working capital losses and are available only for manufacturing and processing industries. The Saskatchewan Economic Development Corporation provides loans to virtually all types and sizes of business for capital assets and working capital.

Government guaranteed loans are arranged by the government but are handled by private sector commercial lenders. Hence, there may be two screening processes to go through -- one with the government and one with the eventual creditor. On top of this these loans may involve extensive discussions between the government agency and the creditor over aspects such as the percentage of the loan to be guaranteed and the degree of monitoring of the loan required by the creditor.

Businessmen may also perceive an important difference between guarantees and loans in terms of what happens if all repayments are not made on schedule. Businessmen often prefer to deal with government because of their greater leniency in case of default. On the other hand, the involvement of private commercial lenders makes guaranteed loans more attractive because they are less affected by the stigma of being government handouts.

The federal government's Small Business Loans Act, administered by Industry, Trade and Commerce, offers loan guarantees to a maximum of $75,000 for capital assets only. The set lending rate is one per cent over prime. The Federal Business Development Bank guarantees up to 60 to 70 per cent of the loan requirements of most small and medium-sized businesses for capital assets and working capital. It assesses a fee of 3 per cent above the lending rate. Industry, Trade and Commerce's Enterprise Development Program and Defence Industry Productivity Program offer loan guarantees as well.

In addition all of the provincial development corporations and economic ministries mentioned above offer loan guarantees in conjunction with loans.

Subsidies are ongoing support mechanisms that depend on continuing action by the recipient. As a result, they are not viewed as up-front financing assistance. They may even not be viewed as a cash flow incentive if the amount of assistance is hard to measure in advance.

Direct equity investments by governments and joint ventures with government agencies will have limited application in Canada. This is largely due to the general attitude that governments should not be investing directly in the private sector. Where governments have entered a joint venture directly, such as with Syncrude, the incentive has not normally been the trigger for the decision to invest, although it has had a marked impact on the timing of private sector investments.

The Federal Business Development Bank will take minority positions in limited circumstances, usually with definite intentions for repurchase or redemption.

At the provincial level, the British Columbia Development Corporation will take minority positions in limited circumstances. The Newfoundland Development Corporation will take minority positions in new or existing companies offering significant benefit to the province in terms of employment, high technology, or utilization of local raw materials. The Quebec Industries Development Corporation will take minority interests in manufacturing and processing companies in limited circumstances.

Tax Incentives

Fast writeoffs for slant and equipment are cash flow incentives and offer no assistance for up-front financing of a project. The federal government has made significant use of this kind of incentive to help Canadian industry modernize existing plants. The measures permit firms to increase allowable depreciation of new machinery and equipment so as to reduce the amount of taxes payable. This tax saving provides a useful source of cash flow with which to repay private sources of financing.

Fast writeoffs are a benefit only to the extent that the recipient actually succeeds in generating taxable profits. Marginally profitable or losing operations get little immediate benefit from this kind of incentive. However, a benefit may be realized over time from the flexible carry-over nature of the Canadian tax depreciation system. Any tax saving is recaptured by the government if the asset is ever sold for more than its written-down tax value.

Whereas the fast writeoff is less frequently used in the United States than in Canada, it is more widely used in Britain and Ireland than here. For example, the governments of Britain and Ireland allow a 100 per cent writeoff for most buildings, machinery, and equipment.

<u>Writeoffs in excess of 100 per cent</u> of an asset's cost have all the same features as a fast writeoff except that the benefit is not ordinarily recaptured upon the sale of the particular asset. The ability of mining and oil and gas operations to write off an extra one-third of the cost of exploration and development in the form of a depletion allowance is a case in point.

<u>Investment tax credits</u>, as is the case with all tax incentives, are awarded according to rules that are statutory or automatic. This means greater certainty and uniformity of application. However, the fact that they reduce the depreciation available on the related assets reduces their perceived benefit to business.

Most businessmen regard investment tax credits as cash flow incentives. Although they act as up-front financing assistance, the funds are only received as a reduction of the tax installments otherwise due during the year in which the investment is made. With large investment projects, there may be insufficient tax liability in the year of investment for the firm to make use of the investment tax credit. When this happens, it becomes merely a potential future cash flow benefit, which may never be received. It is therefore difficult to establish how frequently this incentive goes unused.

Reduced tax rates have been in effect since the tax reforms of 1971. They are important to Canadian-controlled private corporations and to manufacturing and processing businesses as a source of internally generated funds. Obviously, they act as a cash flow incentive, and are contingent upon profits. The benefit is an indirect one; as such, it is rarely linked by the investor to the making of particular investments in productive plant and equipment. The enhanced cash flow from reduced tax rates may however significantly contribute to the company's ability to attract and service private debt sources.

The federal government has over the years introduced a wide array of special tax measures. The accelerated capital cost allowance permits businesses to write off manufacturing and processing equipment and pollution control equipment in two years, and certain Canadian-built vessels in three years. Eligible capital and current expenditures for research and development can be written off at once and incremental increases may qualify for up to 150 per cent write-off. Mining and oil and gas companies also enjoy fast writeoffs as well as special deductions for earned depletion and for exploration for oil and gas in the frontier regions.

An investment tax credit of 7 per cent is available to corporations and individuals investing in qualified property, i.e., most new buildings, machinery and equipment. Higher credits of 7½, 10 and 20 per cent apply to investment in designated regions. Research and development projects are also eligible for credits at rates of 10 to 25 per cent. Currently there is in effect an employment tax credit, administered by the Canada Employment and Immigration Commission. This credit is based on the number of new jobs created and varies depending on geographical location.

The basic corporate income tax rate was reduced to 46 per cent in the early Seventies; the rate on profits from manufacturing and processing activities is 40 per cent. Canadian-controlled private businesses meeting size and activity limitations may obtain up to a 21 per cent reduction in their rate of federal tax payable.

An inventory allowance affords deduction from taxes payable in the amount of 3 per cent of the value of opening inventory. Further, firms may elect to capitalize the costs of borrowed money and to depreciate certain start-up costs so as to remain entitled to deductions that would otherwise expire at the end of the loss carry-forward period. Private corporations may also claim business investment losses in order to eliminate limitations on the deductibility of capital losses.

The Ontario government's budget of April 10, 1979 introduced a new equity investment program, entitled "Small Business Development Program", that offers incentives to corporate and individual investors who buy shares in small business development corporations established for the purpose of directing the invested funds to qualifying businesses. Individuals investing in small business development corporations receive a grant equal to 30 per cent of the cost of their equity shares, while corporations receive a tax credit of the same size against Ontario income taxes.

In Quebec, small and medium-sized manufacturing companies can elect to deposit 50 per cent of their provincial income tax into an industrial incentives fund. Sums deposited can then be used during the following 65 months to discharge up to 25 per cent of an allowable expenditure connected with their manufacturing and processing operations.

Other Incentives and Disincentives

Protective tariffs and quotas provide no direct financing assistance, but may stabilize an environment and restore confidence among private financing sources. A businessman must still know his marketplace well to determine how much protection a particular tariff or quota offers before he proceeds with new investment, and such an assessment may take a long time. On the other hand, the recent stability provided by government to the Canadian footwear and tanning industry and to the Canadian textile industry demonstrates the usefulness of these incentives when concentrated in a meaningful manner.

Crown corporations may not be viewed by businessmen as an incentive at all when they are making a particular investment. Rather, they may be viewed simply as an additional source of competition -- even unfair competition, by virtue of the statutory rights and/or preferential financing arrangements that Crown corporations sometimes enjoy.

Government purchasing policies may be an important factor in stimulating particular kinds of private sector investment in plant and equipment to the extent that they are a reliable and profitable source of business.

The Foreign Investment Review Agency reviews all new business start-ups that are foreign-owned and most acquisitions of control of Canadian businesses. Thus the agency has power to influence the degree of competition in Canada. It may pose a significant disincentive to potential foreign investors in Canada as well as to some Canadian businessmen who see the agency as a potential barrier to selling their business after it has built up to attractive values. This is especially true when the business has received government assistance during its history.

Other agencies also are maintained by the federal and provincial governments to provide statutory and regulatory supervision and assistance. The federal Anti-Dumping Tribunal acts as a watchdog for pricing of imports. There is also a program for remission of duty on imported machinery and equipment not presently produced in Canada. Research foundations provide technical assistance. Federal and provincial sales tax policies occasionally offer temporary cuts or permanent exemptions on certain items.

Additional services are also available to assist businesses. The Federal Business Development Bank and provincial development corporations provide counselling. Industrial information and export data are available from federal and provincial trade departments. Trade shows provide a forum for the exchange of information and the promotion of products and services.

2 Incentives and the Decision to Invest

Motives for Investment

From the viewpoint of the entrepreneur, there are a number of factors, both operational and personal, that lead him to make capital investments.

The most important non-financial factor in the investment decision is the (desire of many individuals to be in business for themselves). The key financial consideration in most cases is the (need for expansion of production facilities) through building new or purchasing existing plant and equipment to meet higher expected demand for products.

Replacement of existing equipment that has broken down, is obsolete, or is operating inefficiently is a frequent motive for investment. Often replacement of equipment may involve modernization: the entrepreneur often believes that he can reduce fixed or variable operating cost by acquiring more advanced equipment. In other cases the entrepreneur may perceive that he must become more competitive in order to continue to serve his present market by investing in research and prototypes to develop new product lines.

Often, investments are required to meet safety standards, satisfy pollution or local legal requirements, or to provide various cultural and social benefits to employees and communities.

Relocation or consolidation of business operations may be necessary to achieve a higher level of marketing effectiveness or a lower level of operating cost. Relocation may also give a firm a competitive advantage over rival firms. Some owners may invest simply to keep their assets fully invested in order to avoid takeover bids, which are especially common in cash-rich public companies.

Firms may need new equipment for diversification into new product lines, new services, or for backward or forward integration. Finally, investment decisions are sometimes subject to a stampede effect. If a competitor establishes a new product line or has success in a new location, others may follow suit merely so as not to be left behind.

These reasons for investment are often based on personal and emotional evaluations. It has been our experience that many businessmen make no explicit financial forecasts to assess capital investment unless compelled to do so to satisfy a private lender or government agency. When completed, financial feasibility studies can stop a project should they predict unacceptable returns. (Once the threshold of acceptability is reached, however, marginal increases in the projected financial returns have little bearing on the individual's investment behaviour, in our opinion.)

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Barriers to Investment

Other factors may prevent businessmen from going ahead with their investment decisions. Some of these factors, of course, are the direct opposites of some of the motives for investment mentioned earlier. Government incentive programs have traditionally attempted to overcome some of these barriers.

Among the strongest deterrents to investment are depressed product markets. Cyclically sensitive industries are repeatedly subject to this state of affairs. Another important barrier is projected profitability of an investment that is below acceptable standards. It is not uncommon for investment projects to be foregone in cases where they would create too much financial strain on the company without new equity capital being available. Competition from large well-established and well-financed multinationals and conglomerates is a strong disincentive to investment in some firms.

Firms planning an investment may be deterred by an inability to secure adequate supplies of raw materials at predictable prices, a shortage of skilled labour and management personnel, or unavailability of specialized equipment.

Investors may fear increased government regulation or interference in the market, such as from the dropping of protective tariffs. They may defer investments because of high inflation or a poor economic outlook. Some entrepreneurs may simply resist change, even when they encounter significant operating problems with present facilities. The rapid pace of technological change prevalent in some industries discourages new investors from entering. Some businesses prefer to leave innovation to others and adopt the less complicated and costly approach of product duplication. New products pose the risk of lack of acceptance by the market, a risk many investors are unwilling or unable to assume.

The fear of completion from imports may discourage potentially profitable investments. The value of the Canadian dollar in foreign currency markets may be a powerful incentive or disincentive for exporting and import-competing industries.

Depending on circumstances, a takeover of an existing firm may be more attractive financially and for other reasons than building new facilities. Such circumstances have certainly occurred in Canada in recent years and may be an essential step in the rationalization of certain industries.

[In order to be effective, government incentives must have a significant impact upon the major investment criteria that businessmen use in their decision-making process.] It is why we examined above the positive and negative criteria used by businessmen in making investment decisions, and indicated an approximate ranking of these criteria by importance. Unfortunately, little quantitative research has been conducted in Canada on the relative importance of investment criteria. Research of this sort would certainly be useful in the design of general and specific industrial programs to stimulate capital investment.

Size of Businesses

We shall now discuss the various types of incentives and the factors affecting the "invest/do not invest" decision from the viewpoint of businessmen in firms of different sizes.

Small and medium-sized businesses rarely view government incentives of any type as the trigger that leads them to invest, in our practical experience. We must, however, draw a distinction between the trigger to invest and the essential factors that allow an otherwise blocked investment to proceed.

There forever is a vast number of businessmen attempting to start or to expand a small business. Their rationale for doing so is quite often not financial. The most frequent problem they face (and the major barrier in their minds) is getting financial backing. Since lack of up-front financing is the major barrier for small and medium-sized businesses, their investments are not greatly influenced by the availability of cash flow incentives such as fast writeoffs or investment tax credits. *

Sources of financing for small businesses may be listed in the following descending order of importance: personal resources, those of friends, relatives, or business acquaintances, the local bank, government assistance, and venture capitalists. We believe that, for many projects, financing is at least partly arranged prior to seeking government assistance. Although grants and loans can play an important part in permitting an otherwise blocked investment to proceed, even these direct and discretionary incentives are often only given to those who are able to obtain most of the financial backing on their own. In our opinion, government agencies are reluctant to go out on a limb to support the project of a small or medium-sized firm that truly cannot attract financing elsewhere. For this reason, we have serious doubts about how often even direct, discretionary incentives are the key factor in allowing an investment to go forth. Much work would be required to shed any real light on this question.

The impact of other incentives such as protective tariffs and government purchasing policies on small-business investment projects is also difficult to assess. We suspect that protective tariffs help more to maintain existing operations than they do to stimulate new investment.

Similarly, government supply contracts do little to stimulate investment in new productive facilities unless the contracts are of a fairly long-term nature. Many businessmen are fearful of the uncertain nature of government contracts.

Despite determined efforts, government communication with small businesses to advertise the availability of incentive assistance has not been effective. Businessmen cannot react to something of which they are unaware. We believe that governments have problems in this regard for two principal reasons. Firstly, the entrepreneur is a busy man; everything must compete for the time and attention of one man charged with the multiple responsibilities of production, finance, marketing, personnel, and general administration. Governments may do better to aim their detailed information at accountants, lawyers, and so forth, who frequently counsel smaller businesses. They should perhaps inform the small businessman himself only about where to go tc seek help and about the general nature of help available. The recent expansion of the Federal Business Information Centre is a positive step in this direction. Secondly, the specific incentive programs and number of disbursing agencies have changed too often, leaving most advisors to this segment of the business community ill-informed, not to mention the small businessman himself. (See the section Constancy of the Rules below.)

In summary, we feel that up-front financing assistance tailored to individual needs has the greatest chance of stimulating investment by small businesses. However, grant and loan agencies will have to become much less risk-averse if they are to have a significant impact on investment.

Large businesses, it is reasonable to assume, have people on staff or financial advisors who have the time to learn which government incentives are available to them and to assess their impact on a proposed project. However, we should emphasize at the outset that only the largest businesses are themselves well-informed about the various government incentives.

Most large businesses do not make decisions quickly; sometimes investments in productive facilities are planned for several years before they are actually carried through. Unlike small and medium-sized firms, large businesses make some calculations, such as discounted cash flow statements, the rate of return, or the payback period, to assess the profitability of a proposed new project. Further, they normally have already established access to sources of financing. These generalizations should not be overdone, as there are exceptions. Some large firms are very quick to react and are just as risk-oriented as smaller businesses.

It seems useful to make a distinction between replacement investment and investment for expansion or modernization. The former is a (fairly automatic decision and is rarely if ever induced by incentives.) The timing of the replacement may well be altered in response to incentives.

As for "new" investment, it is very much subject to the assessment by the firm of its own market prospects and of the general economic outlook. Often inspired by company ego or a desire to be represented in geographic area or range of products, investment is undertaken when market opportunities exist, when market share can be increased, or when existing facilities are overutilized. To put this another way, the surest thing to stop an investment project is a depressed market. Larger businesses know how much volume they need to be profitable. This is also why the overworked phrase "low business confidence" remains relevant to the investment climate. Businesses who see persistent inflation ahead may fear governments will apply the squeeze and their markets will dry up; unstable political prospects, such as that arising from the Quebec situation, or uncertainty regarding future competitive position as a result of the volatile exchange rate and tariff negotiations may depress investment for the same reason. Cost factors also matter a great deal.

The high cost of borrowing, or fear of product prices not keeping up with rising cost, may be a powerful deterrent to investment.

The point is that government investment incentives are rarely going to make a business invest when the market signals and outlook are unfavourable. This would apply especially to the mid-Seventies when more than a few factors were negative, as inflation combined with slow growth, a poor competitive position and high cost of capital.

Large businesses do not assess the impact of incentives separately. We believe that they rarely assess the marginal impact of any one incentive on the feasibility of a given project. Instead, they lump the availability of one or more government incentives into an overall feasibility study for the project. We emphasize this point because, although government incentives may collectively have a bearing on the decision-making process, we seriously doubt whether larger businesses ever attribute the feasibility of a project to any one incentive. Although decision-makers may be told that a project is financially viable, they rarely ask themselves whether it is the incentives that bring the project up to an acceptable level for the rate of return or payback period. Therefore, we feel that for the large business it is better to assess the effectiveness of incentives as a package. The fast writeoff for machinery and equipment used in manufacturing and processing of 50 per cent a year may be important to many large businesses but, in our opinion, even this automatic incentive is not a dominant factor in the minds of businessmen when they decide to invest.

Large businesses are sensitive to both up-front financing assistance and cash flow assistance. We do not think that the effectiveness of incentives hinges on this distinction because larger businesses place importance on both types.

We doubt whether much new investment is actually initiated as a result of any one incentive or even by government incentives collectively. If we define a windfall gain as a government incentive received for an investment that would have occurred sometime even without the incentive, then there is a significant element of windfall gain in most government incentives. This is true mostly of the automatic incentives such as fast writeoffs and investment tax credits.

Of all the other incentives, it is perhaps only joint ventures between government and private industry that have an apparent effect on investment, as in the case of Syncrude. These are exceptional situations and they would have to be analysed individually to determine if there was an effect on the decision whether to invest, rather than on timing alone.

Canadian and Foreign Ownership

Canadian-owned and foreign-owned businesses share basically the same inducements to invest but react differently to investment barriers. By foreign-owned, we mean companies whose clear control is held by some foreign corporation or individual -- frequently 100 per cent of the ownership. By Canadian-owned, we mean companies that have no significant number of foreign shareholders and a majority of whose shares are held by people residing in Canada. Canada has a large element of foreign ownership in virtually all of its industries and especially in manufacturing industries where much of the investment in new productive facilities is made.

The factors which cause the decision to invest in new productive facilities are basically the same for foreign and Canadian-owned firms. However, we believe that the barriers, real or perceived, to new investment in Canada may be different depending on ownership of the company. Our experience would lead us to believe that Canadian managers of foreign-owned subsidiaries do not often make decisions to expand local plant facilities, or to significantly increase machinery and equipment capacity, without very direct involvement from their parent company. Indeed, in many cases, those new investment decisions are made entirely by parent company personnel, with the Canadian managers providing mainly an informational input. It is, of course, difficult to make absolute statements in this regard as some Canadian subsidiaries operate quite autonomously, but we feel that the majority do not. This question of where investment decisions are really made has occupied the attention of Canadians since the 1960s when the implications of foreign ownership became a national concern.

There are a number of real and psychological barriers to new investment in Canada, which are more significant to the foreign investor than to the Canadian investor.

The instability of the Canadian dollar is perhaps the major one. If the foreign investor is looking at how much profit he can one day return to his home country, all of his projections appear to be on very soft ground today, given the rapid fluctuations in the exchange rate of the Canadian dollar. At times, as during the summer and fall of 1978, many foreign investors pulled money out of Canada for this reason. They feared both further declines of the Canadian dollar and the imposition of foreign exchange controls.

The Foreign Investment Review Agency also has a restraining influence. Although not many new investments are actually turned down, we believe that there are many that simply do not proceed because of the mere existence of the review process and the publicity surrounding it, which suggests to prospective foreign investors that not all of their investment plans for Canada are welcome. We frequently deal with foreign businessmen who simply do not understand or do not want to understand Canadian concern with foreign ownership. The existence of FIRA is often uppermost in their minds in the formative stages of investment planning, outweighing such positive factors as Canadian government incentives.

The high personal tax rate system in Canada is another deterrent to investment. A foreign businessman who contemplates shifting key personnel to Canada in order to make the operation successful knows that many of them will demand higher salaries to offset the higher tax liabilities. This extra cost is clearly in the minds of American and other non-Canadian businessmen when looking at new investments in Canada.

We suspect that a foreign businessman would also have to foresee a higher rate of return on a Canadian investment than his Canadian counterpart would. That is to say, the foreign businessman would have to have a higher degree of business confidence with his Canadian investment. Foreigners are naturally more familiar with, and therefore more comfortable with, the rules, regulations, and incentives at home than they are with the financial technicalities and incentives in Canada.

No doubt other factors lie in particular circumstances, such as more extensive and costly social programs in Canada, the less-than-satisfactory strike record, the shorter production runs, or the higher interest rates. We do not want to suggest that all of these concerns are valid ones, but these and others are commonly expressed by foreign businessmen looking into new investment possibilities in Canada. They are therefore perceptions, if not realities. These real or psychological barriers in the minds of foreign businessmen become particularly relevant for multinationals faced with choosing between servicing new international markets from Canada or from some other country.

All of this leads us to conclude that foreign businesses will need that much more push to invest in Canada than will Canadian firms. American and other foreign businessmen may also view the various government incentives a little differently than would Canadians. We detect a greater reluctance among foreign businesses or even foreign-owned Canadian businesses to pursue grants from federal or provincial governments than among Canadian-owned firms. Perhaps foreign firms are uneasy about seeking free money from a government not their own. Therefore, while we believe that all large businesses have a preference for automatic types of incentives, such as tax incentives, over discretionary grants, that preference is a little more marked among foreign-owned businesses.

Profitability of the Firm

Marginal or highly levered firms normally look harder at all possible sources of assistance, including government incentives that may aid new investment, than do more profitable enterprises. Because not all businesses are earning the same rate of return on their existing lines of business, the ability to finance new investments from internally generated funds can vary dramatically from business to business. The marginal firm will place more importance on up-front financing, so grants and loans will have a greater impact on its decisions. Of course, cash flow and the cost of capital in particular, also remain very important to the low-profit firm. Although the company with established profits will seek whatever types of government incentives it feels it may qualify for, it would clearly have a preference for the more automatic cash flow incentives such as investment tax credits or fast writeoffs. While those companies no doubt are influenced by automatic incentives in their decision-making process in the long run, they are more likely to view them as windfall gains, as we mentioned above.

A study should be made of how many companies make investments in productive facilities at a time when they have insufficient profits to claim all their tax depreciation or investment tax credits. We believe that the findings would show that perhaps as many as half of all firms fall into this category. They would, of course, place little importance on cash flow incentives that cannot be used when earned. Moreover, while both tax depreciation and tax credits may be carried forward, no benefit can be realized until profitability is obtained. Future cash savings as a result of subsequent profitability do little to reduce the immediate cost of investing. Perhaps the government should consider a one or two-year carry-back privilege for the investment tax credit, which would make the benefit of this incentive much more predictable.

Capital Intensiveness

Capital intensive businesses, usually characterized by a high debt-to-equity ratio, tend to have a greater financing problem than labour-intensive ones. The former must arrange for the up-front financing of significant new investments, while the latter generally has no similar difficulties in expanding its work force. Capital intensive firms normally prefer any incentives, such as grants, loans, tax credits, or fast writeoffs, which are aimed directly at the purchase of new productive facilities over indirect incentives such as reduced tax rates. Since the cost of borrowing weighs so heavily in the investment decision, incentives such as income debentures or term-preferred shares, which were aimed at reducing this cost, probably have the greatest impact on the investment decisions of capital intensive firms. This is so because they are likely to lack sufficient taxable income to fully exploit all available tax incentives such as fast writeoffs or investment tax credits.

3 Other Aspects of the Decision to Invest

The previous part of this paper has been mainly concerned with whether or not government incentives trigger or initiate the decision to invest in productive plant and equipment. Having concluded that most government incentives have only a marginal impact on the basic decision whether or not to invest, we now shall comment on the effect of incentives on other aspects of the decision, such as its timing, the choice of location, or the size and quality of the investment. In doing so we shall continue to distinguish firms by size, ownership and other attributes.

Timing

Some government incentives are designed as anti-cyclical fiscal policy tools and should be judged as successful if they merely influence the timing of investments. The present 7 per cent investment tax credit (10 and 20 per cent in underdeveloped regions) was first introduced as a short-term stimulus for investment in certain industries and it may have been aimed mainly at the timing of these types of investment. Other short-term measures used in the not too distant past are the deferred depreciation on office buildings, the ability to write off 115 per cent of the cost of certain assets, and temporary surtaxes or tax credits.

Most small and medium-sized businessmen are not aware of the existence of short-term government incentives or disincentives. For example, most small businessmen would not know the rate of the investment tax credit, let alone the period it is in effect. Therefore, we conclude that these play only a small role in affecting the timing of their investments. On the other hand, most small businessmen know that they can get a full year's tax depreciation on assets bought very late in the year, since that has been true for many years. Thus, the number of investments by small and large businesses increases a little just prior to year-end, although we wonder whether this tax rule was ever designed for this reason.

Larger businesses, with the time and resources to measure the impact of government incentives, will indeed pay more attention to the timing of investments in view of the possible benefits from incentive measures. Indeed, government incentives can have a greater impact on the timing of investments, particularly those made by larger and more sophisticated businesses, than on any other aspect of the investment decision. We have seen numerous examples of businesses trying to speed up an investment prior to the expiry of an incentive; similarly, we have seen an equal number of examples of firms holding back investments until after a budget that they anticipate may introduce incentives.

Automatic incentives are more apt to alter the timing of replacement investment and they have only a small effect on new investment. Discretionary incentives on the other hand, are more likely to influence new investment. By and large, it is the timing of replacement investment which is more readily influenced by the temporary availability or expectation of incentives. Replacement may be deferred or speeded up by several months, although not likely by more than a year. By contrast, the timing of new investment projects is not readily altered, except when there is a very large incentive to this end.

We do not believe that if a small incentive like a 5 or 7 per cent investment tax credit were introduced for, say, one year, it would induce many businessmen to try and alter the timing of significant new investments. Now that both the fast writeoff for manufacturing and processing equipment and the investment tax credit have been made permanent measures, the only automatic rule left to affect timing of investments (at least in a minor way) is the full-year depreciation for assets bought late in the year.

We do not believe that there is any appreciable difference between the way in which Canadian and foreign-owned businesses respond to incentives affecting the timing of investments. If, however, there is a difference, it would be due to the lower degree of awareness by foreign businessmen of Canadian incentive programs.

A large company with established profits is in a good position to speed up or delay investments in machinery and equipment, and perhaps even some investments in bricks and mortar, in order to capitalize on fairly short-term investment incentives. Once again, we stress that there is an element of windfall gain in this category, but at least it has the possibility of altering the timing of the investment.

The capital intensive firm can be expected to have a more carefully planned capital investment program. Because of financing restrictions or perhaps because of the inability to use tax-oriented investment incentives, it is likely to be less flexible regarding the timing of capital investments.

Location

A thorough discussion of the merits and/or problems of regional development incentives is beyond the scope of this report. However, we would be remiss in not addressing the question of location because it is particularly relevant when the choice is between investing in or out of Canada. Much as grants, loans, and other incentives from the Department of Regional Economic Expansion are aimed at encouraging investment in the slower-growth regions of Canada can the overall package of government incentives be said to encourage investment within Canada rather than outside Canada.

We believe that several different types of incentives do alter the location aspect of the investment decision. There is no doubt that DREE-type incentives have encouraged some corporations to locate significant plant and equipment in the more depressed areas of Canada. This point, however, raises the question of the criteria to be used in determining how much ought to be spent in order to create a job in any one location.

Conventional levels of assistance for locating in depressed areas -- say, 20 to 30 per cent of up-front costs -- are not enough to induce very many businessmen to locate a plant in the Maritimes if they think it makes more sense economically to do so in southern Ontario. This level of financial assistance may be enough to induce firms to choose a new site for their plants, say, 100 to 200 miles away from larger cities. We have seen many examples of this. But greater geographic shifts in new plant sites rarely occur and, when they do, the incentives are quite large relative to the total cost of the project. One reason why large shifts do not occur may be the inability of firms to quantify the full extent of increased operating costs that may result from locating in a designated area, such as possible shortages of skilled labour in the future. As an aside, we question the ability of up-front incentives to address the relocation problem and speculate that ongoing incentives, such as permanently lowered rates of corporate tax for firms in designated areas, would better help to compensate for unpredictable operating costs. As things stand, most conventional DREE-type incentives must be regarded as windfall gains to companies that would have invested in designated regions anyway. There may of course have been a desirable impact on the timing of such investment.

There is little evidence to show that higher investment tax credits of 7½ or 10 per cent instead of 5 per cent for depressed areas alone have any significant effect on the choice of location of new investment. We suspect the same is largely true for replacement investment. Although investment tax credits have now been increased to 10 and 20 per cent for depressed areas, they will still not likely affect the choice of location because this tax credit is taxable, which reduces its real value to the investor. The tax credit reduces the cost of the related asset for purposes of computing subsequent depreciation claims, thus subjecting the amount of the tax credit itself to tax, in due course. However, higher investment tax credits will likely have a positive impact on investments which are indigenous to the depressed areas.

When a firm is faced with choosing between expanding facilities or building new facilities elsewhere, there is normally a strong bias in favour of the former. This seems to apply whether the new location is 100 or 1,000 miles away. We believe that this bias is both real and rational, since there are many cost savings to be derived from expanding existing facilities rather than creating at a new location a totally new management team, labour force, arrangements with suppliers, and so forth.

These various considerations relating to the effect of incentives on choice of location within Canada also play a part in the choice whether to invest in Canada or elsewhere. It is, however, even more difficult to make any statements about effectiveness of incentives in the latter case, since there are so many factors that play a role. Some important factors were discussed earlier in the section "Canadian and Foreign Ownership". No doubt these factors reinforce the natural bias of the foreign businessman for locating new investment in his home country. In the late Seventies, however, even Canadian businessmen have been looking to the southern states of the United States, or even to more distant countries for new plant sites, especially for those serving foreign markets. This reflects the reduced level of business confidence in the Canadian economy of many Canadian and foreign businessmen in recent years, a factor which is difficult for government incentive programs to overcome.

Size and Quality

Our experience does not tell us very much about whether government incentives will encourage investors to build deluxe or very economical plants. We think that most investment decisions, either for significant expansion of plant facilities or for modernizing or updating machinery and equipment, are made for very particular technical and market-oriented reasons. Rarely would the investor change the size or quality of his new investment because 10 or 20 per cent of the cost would be borne by the government. Perhaps in situations where the government was paying a very large share of the cost, this might become a factor.

4 General Characteristics of Government Incentives

Now that we have expressed some observations on how different types of incentives affect the various aspects of the investment decisions of different types of businesses, we turn to general features of government incentive programs and policies that have a bearing on their effectiveness. These features are the size of the incentive, changes in the rules, government risk, duration of incentives, and the vagaries of passing enabling legislation for incentives.

Size of the Incentive

We believe that the size of a particular incentive, relative to the overall cost of the planned investment, is one of the most important aspects that causes a particular incentive to be effective or ineffective. Government incentives have often been too small or too broad in scope or have been offered for too short a time to have had the desired effect on investment decisions.

Any investor has what might be called an attention threshold or interest threshold. Government incentives of which he is aware, and which have only a minor effect on the manner in which he is assessing his new investment, may well fall below his attention threshold and be completely ignored. For example, we believe that the 5 per cent investment tax credit, which reduces the depreciable base of the asset purchased, fell below the attention threshold of most investors. We do not expect any different reaction to the higher 7 per cent tax credit which took effect in November 1978.

Some incentives, however, do exceed the attention threshold of investors, especially those pertaining to multiple unit residential buildings, oil and gas drilling funds, Canadian films, income debentures and term-preferred shares, tax-oriented leasing, and reduced provincial sales taxes.

Multiple unit residential buildings (MURBs). Owners of newly constructed rental apartment buildings may deduct tax losses on the building from their normal stream of income from other sources. The losses arise from interest charges and depreciation, which may exceed the rent earned on those buildings. It works as follows: Developers of apartment building form syndicates of numerous individual investors and construct a MURB on their behalf. Each investor may own one or two units in a particular building. Most of the building would be financed with long-term borrowing. Each owner can claim, as a deduction from his taxable income, his portion of depreciation on the building and of interest payments on the mortgage, while he declares rent collected as income. This may create a substantial tax loss, at least in the early years of the operation of the building. Some MURB schemes are so structured that most of the investor's outlay, which may be in the order of $10,000, can be recouped in the form of tax savings in the first year or two. The rentals from the buildings are usually high enough to service the payments on the mortgage so that there is no annual cash drain to the individual investor. When a unit is sold, the tax savings claimed in earlier years must be repaid. But the investor may benefit meanwhile from tax deferral and capital appreciation in the building. Hence, he is using tax dollars that he would otherwise pay to the government to earn a share in any capital appreciation of the building.

Because almost everyone believes in the upside potential of real estate investment, and because most of the investment cost is quickly recouped, this kind of investment easily crosses the attention threshold of most investors. MURBs have caused a buzz of activity among higher-income taxpayers, which has permitted a number of real estate developers to profitably build and sell apartment buildings. These buildings are being built in soft markets that would not otherwise attract the necessary equity financing. The MURB plan expires for buildings commenced after 1979.

Oil and gas drilling funds work on much the same principle. A person participating in a drilling fund based in more conventional areas like Alberta can write off 100 per cent of his exploration costs against his other personal income and can also write off an extra one-third of those costs against production income. A participant in a new frontier exploration drilling fund in areas like the Beaufort Sea has since April 1, 1977 been able to write off 167 per cent of the exploration and development costs against his other income and an extra one-third, for a total of 200 per cent of this exploration costs against production income. This extra writeoff for frontier areas is to be phased out during 1980. Thus a person in the 50 per cent tax bracket who participates in a fund with some production income and with drilling costs in the Beaufort Sea can completely recover his investment through tax savings. The tax rates of many people actually exceed 50 per cent and so this type of incentive easily surpasses their attention threshold, especially when the investment has some upside potential, which is certainly the case with Alberta-based drilling funds.

No doubt the objective of these government incentives is to get as much private sector drilling for oil and gas as possible, even if the government is bearing a very large share of the overall cost. A desire by government to learn whether sufficient natural resource reserves in the far north justify the building of the world's costliest pipeline and to determine whether there are sufficient conventional oil and gas reserves to avoid national short-falls by the late 1980s may be at the heart of these generous incentives, which have clearly been effective.

Canadian films are subject to the same principle. The investor is permitted to write off 100 per cent of his cost against other income. Although early Canadian tax-shelter films have not been successful, a whole industry of technicians and financiers has emerged in Canada in recent years. The prospect of Canadian films has improved significantly as a result. In 1978 and 1979, Canadian investors have responded enthusiastically to tax incentives for Canadian film and television productions.

Income debentures and term-preferred shares, which were ended in November 1978, were financing techniques that reduced a borrower's interest cost to approximately 60 per cent of the conventional cost. The Canadian government actually bore the cost of this reduction through tax savings by creditors, who were typically banks. Income debentures and term-preferred shares are basically debt instruments, but for tax purposes they are regarded as equity capital. Return on this capital is taxed as profit in the hands of the company, but dividends paid are not taxed in the hand of the creditor. The creditor could thus reduce his lending rate and maintain an after-tax position equal to the alternative case where he would hold long-term debt. The borrower would benefit from this lower rate if he had no taxable profits, and this has been the case, in recent years, for a number of capital-intensive or marginally profitable companies as a result of various tax incentives. These companies, as it were, traded their surplus tax reductions away to taxpaying creditors in return for reduced borrowing cost.

This type of financing had existed in Canada for more than a quarter century but had grown more popular during the last few years. Although income debentures and term-preferred shares solved a variety of tax and financing problems of investors and borrowers, some portion of the funds were used to finance new investment in plant and machinery. The problem in assessing their use in financing new capital investment is complicated by the fact that they were also frequently used to merely replace existing debt and to relieve the cash flow squeeze many corporations experienced in the mid-Seventies. From our own experience and from discussions with bankers, we conclude that this type of incentive had large elements of both financing of new facilities and conversion of existing debt.

Tax-oriented leasing, prior to the federal budget, was another arrangement between firms and their financiers that served much the same end as income debentures and term-preferred shares. The finance company would own airplanes, railway boxcars, and other costly pieces of machinery to rent them under long-term leases for the life of the asset. Because many of these large capital assets had fairly high tax depreciation rates and because many of them attracted investment tax credits, the finance company found itself with tax losses from depreciation and interest charges in excess of the rental income on the equipment. They were permitted to claim these tax losses against profits from other financing activities such as their more mature leases. The finance company, through very sophisticated computations, actually passed much of the benefit of their tax saving back to the lessee in the form of lower lease payments. The lessee often found that the implicit rate of interest in his lease payments was significantly lower than the borrowing costs of an asset bought directly.

In addition to the reduced cost of borrowing with tax-oriented leases, many businesses also found leasing to be the only way they could get around strained debt-to-equity ratios or legal restrictions in trust indentures for existing debt in order to make new investments in large capital assets. Leasing has been a form of off-balance sheet financing for many businesses. It certainly passed the attention threshold test and no doubt acted as an effective incentive to investment when it was in effect.

Reduced provincial sales tax is another example of incentive size affecting investment. In 1978, the federal government financed a significant reduction in provincial sales taxes in all provinces. Although we have not seen any studies conducted on the effect of this temporary action, we suspect that the results were mixed. We observe that a price reduction of 3 or 4 percentage points did not influence the buying habits of consumers in their everyday purchases of clothing, notions, or similar small items. Consumers contemplating the purchase of a larger item such as an automobile, however, seemed to have rushed out to make their purchase before the expiry of this short-term incentive. Hence, only when the actual tax saving was large did it pass the attention threshold test. Furthermore, only the timing of the investment was affected, not the decision to invest itself.

Constancy of the Rules

Incentive programs are changed too often. We believe that frequent changes weaken the effectiveness of incentives for small and medium-sized businesses. While the same applies to large firms, the effect is not so significant.

Much has been written about the government's poor performance in communicating its programs to the public, especially to the small businessman. Limited success in this area does not mean a lack of effort by the various federal and provincial bodies, but they have fallen short for several basic reasons.

It is understandable that governments must occasionally change their programs so as to direct money to those sectors most in need of incentives. What contributes to the lack of understanding of incentives, and thus to their ineffectiveness, is not just the rate with which the actual rules change, but also the government's tendency to create new agencies to manage new programs and modifications in old programs. Hence, small businesses have difficulty in keeping abreast of what incentives are available and also in learning where to turn for assistance. Most small businessmen are counselled by friends and business acquaintances, by their bank manager, their accountant, or their lawyer. But most local bank managers and smaller professional firms have the same difficulty in remaining informed abcut the current state of government incentives.

We believe that (the image and effectiveness of government incentives would be significantly enhanced if most government incentives were managed and distributed through a small number of agencies whose name did not change over the years, but whose specific programs might be altered when deemed necessary.

A second reason is the government's ill-founded propensity to confuse businessmen with catchy names and acronyms for incentive programs. This habit has been referred to as the alphabet soup syndrome and has probably done more damage than good to the cause of educating the public. A classic case in point is the myriad of programs administered by the federal Department of Industry, Trade and Commerce. This one agency had no less than seven different programs: AAA, PAIT, GAAP, PIDA, IDAP, PEP, and FTIAP. A step in the right direction was taken on April 1, 1977, when all of these programs were consolidated under the umbrella program of EDP, the Enterprise Development Program. However, this may have caused more confusion than it contributed to clarity, as remnants of the old programs, such as outstanding PAIT projects, still exist in some companies, yet it is no longer possible to apply for them. Even some officials of Industry, Trade and Commerce still refer to components of the new program by way of the old names. A review of a recent federal publication entitled -- what else -- <u>ABC</u> (Assistance to Business in Canada), indicates that there are at least 68 different programs at the federal level alone that are referred to by way of an acronym. We suggest that, at least for the sake of the public, an effort should be made to dispense with this annoying practice.

There appears to be a need for sunset laws to govern the life span of not only specific programs but also some of the existing agencies. If we had fewer agencies this need may only apply to individual programs. Government agencies appear to have been created without contemplating an ultimate end to their usefulness. The political process then makes their demise too slow or too awkward to achieve.

(Governments would be advised to concentrate on a smaller number of agencies with well-defined goals to distribute all discretionary incentives.) The names of such agencies should not change over time; only their people and programs should be modified. The names of the Federal Business Development Bank and provincial organizations such as the Ontario Development Corporation are becoming reasonably well-known to small businessmen and their usual advisors, and such agencies should carry the primary responsibility for administering incentive programs.

Larger businesses also have complained that they cannot react to government incentives because the rules of the game change too rapidly to allow them to include incentive programs in their long-range capital investment plans. The firms that can quickly alter investment decisions such as minor modernizations of machinery and equipment may be able to take advantage of those changes and not complain about the continuous changing of the rules. But other firms contemplating longer term investment plans will be left out because of a change in the rules in the meantime. For them, incentives are ineffective.

For example, the Ontario Development Corporation in February 1979 announced that its annual budget had been surpassed and that all loan applications in process would be frozen while the entire structure and purpose of the ODC was being re-evaluated. People working with the ODC to finalize the financing of their proposed new investments had to defer their investment plans during the waiting period, which turned out to be eight or nine weeks. It would be interesting to determine how many companies chose to abandon their investment plans completely because they did not have alternate sources of financing available to them. Furthermore, we are sure that they will have a reduced willingness to rely on the ODC organization in the future.

(Incentive program rules change most frequently for natural resource investment). When oil and gas companies were looking at the feasibility of new oil and gas fields in the late 1960s, they should have been projecting the profits and loss from operating wells for at least the next 10 years. They could not, however, have anticipated the violent changes in tax rules that occurred during the following decade. Changes that would have had a bearing on the ultimate profitability of those oil and gas fields discovered in the late 1960s include those for depletion incentives and provincial royalty expenses. Depletion incentives were changed from an automatic percentage of the company's income to an earned depletion concept, which required further expenditure for exploration and development. Provincial royalty expenses, which themselves grew in tandem with oil and gas prices, were suddenly disallowed in calculating taxable income, as a result of a federal/provincial dispute over oil and gas revenues. This pushed the effective tax rates in many companies up to very high levels and, in extreme situations, to more than 100 per cent.

Some government incentives, such as the 7 per cent investment tax credit, the 50 per cent fast write-off for manufacturing and processing machinery and equipment, and the reduced tax rates for manufacturing and processing profits, have been converted to permanent incentives under our tax laws. Larger businesses with the long lead times necessary to plan investments now should be able to rely on the same rates until the new investment comes on stream.

Because of past changes, however, they may be sceptical about proceeding if some supposedly permanent investment incentive is important to the viability of the project. For example, financing with income debentures and term-preferred shares converted some non-viable projects into viable ones. But, when they were curtailed in the November 1978 budget, some investments had to be redesigned and others dropped.

Governments may even err by extending short-term incentives too often. Tax incentives for multiple unit residential buildings and the 5 per cent investment tax credit are good examples. The MURB has clearly led to an increase in apartment construction and it has been more effective than most incentives. However, this incentive has been extended two or three times for an additional one-year period, making it less effective. Governments could better maintain their credibility by keeping to the timing schedules of their short-term automatic incentives.

Government Risk

What we might call government risk or the possibility of government interference in business investment decisions is a rather intangible factor but one that we have heard expressed fairly frequently in recent years. Few people today should have to be convinced that the

Quebec political situation is turning otherwise viable investment decisions in Quebec into decisions to invest elsewhere or decisions not to invest at all. However, the same kind of concerns are also expressed by foreign investors vis-à-vis the Canadian government and other provincial governments. These fears occur mainly in the natural resource area. The nationalization of the Saskatchewan potash mines and the takeover of privately owned companies by Crown corporations, such as Petro-Canada and the Canada Development Corporation, can make foreign investors uneasy about considering large new investment in Canada. Even if the Quebec government were to announce that it was no longer interested in buying the Asbestos Corporation, past indications that it might do so could still prevent the sale to a third party for fear that the government could once again decide to purchase those assets sometime in the future.

The current trend towards freer trade and multinational trade negotiations may be seen by some as another example of government risk. Some investments in the past have been made in view of the protection of existing tariffs or import quotas. Should those be removed, a previously viable business decision to invest could be reversed in fairly short order. Now that the MTN negotiations have been largely concluded, the negative impact of uncertainty should be reduced. However, the fact that several protective tariffs were lowered will give some businessmen considering long-term Canadian investments fear that other changes could damage him in the future.

Duration of Incentives

As discussed earlier, we believe that government incentives can affect the timing of capital investments more than any other aspect. An investment incentive introduced for a period as short as, say, six months might cause an increase in investment in those six months. It would have to be viewed largely as a windfall gain, however, for we believe that most of that investment would have occurred at least close to that six-month period in any event. Some people would argue that even a one or two-year period is too short for an incentive to affect timing of major investment projects in more than a very minor way. We suggest that, when a business is making a significant new investment in plant or equipment, the timing is not likely to be altered by more than several months. We therefore expect that permanent investment incentives lasting three years or more are more likely to have a beneficial impact on investment decisions than are incentives of a shorter duration.

From Announcement to Enactment

Passing enabling legislation for incentives usually takes several months and sometimes more than a year after they have been announced in a budget. Investors who are in a position to alter their investment decisions as a result of the announcement may therefore be held back in adjusting their expenditure plans for a considerable time. Most businessmen will not begin to react to a new incentive until they are fairly confident the law will be passed and retained. This would be the case if a strong majority government is at hand to pass the enabling legislation.

Unsettled political conditions at the federal level during the past couple of years, probably have lengthened the reaction time of businessmen to such new measures as were introduced, thereby reducing their effectiveness. In this manner, political uncertainty adds to the lag by which businesses respond to incentives, a lag which in the case of new investments in plant and equipment could be as long as a few years.

5 Common Questions about Government Incentives

We would now like to offer our observations on some of the more common questions or accusations leveled at government incentives.

Do government incentive programs compete with one another?

There is little doubt that provincial incentive programs compete with each other in order to attract new investment to their provinces. This may be unavoidable. It seems to us, however, that the incentives in all provinces are higher than necessary because of the poker game approach that most governments use in trying to outbid their neighbours for new investment and jobs. Put another way, we suspect that if there were no incentives for locating in the golden triangle of central Canada, smaller incentives could be used to attract investment to more remote areas.

Are automatic incentives more effective than discretionary ones?

In our judgment the answer is yes if the effect is measured as the change in aggregate investment.

Smaller businesses are most affected by discretionary incentives to invest. They have a high political profile and their activity is becoming more important to the economy. Therefore, governments should direct the focus of discretionary incentives largely to smaller businesses so that they can be encouraged to invest and expand. Such emphasis would make discretionary incentives even more important as a stimulus to the growth of small business in Canada.

There are, however, several drawbacks to discretionary incentives, especially as they apply to larger businesses. Social objectives underlying incentives may be inconsistent with long-run growth and productivity goals. For example, support of industries which are no longer economically viable may be more costly than allowing economic rationalization to occur. The process of seeking government approval often slows investment planning and adds to the cost of seeking incentives. This usually involves extra paperwork and additional reporting requirements. There may be time constraints regarding starting and completion dates for the project. It the assistance comes in stages, any delays could create a need for secondary or bridge financing. In addition, the prior approval concept of discretionary incentives is often administered on a purely arbitrary basis. Are civil servants the best people to be exercising power over the allocation of scarce resources? Some potential investors may curtail further study into the feasibility of a project simply to avoid direct government involvement in their affairs. Whether or not this particular criticism has merit, it has entered the public consciousness in much the same way that the mere presence of the Foreign Investment Review Agency poses a constraint to foreign investment, even though FIRA seldom acts to reject actual investment proposals.

We believe automatic incentives have a greater impact on total investment in productive facilities than do discretionary ones, especially for medium-sized and large businesses. They avoid the initial screening process by outsiders and reduce time delays. Although automatic incentives often become windfall gains to businesses, this extra cost to government may be less than the cost of administering discretionary programs. Therefore, we think that governments should favour automatic incentives for larger businesses. Discretionary programs should be reserved for small businesses.

Do tax incentives to foreign-owned businesses represent a shift in tax dollars to a foreign government's treasury?

This proposition has been discussed on numerous occasions by tax theorists and economists. When a Canadian subsidiary distributes dividends to its parent company in the United States, for example, the parent company is not only taxed on the dividend received but also on the actual profit of the Canadian subsidiary from which the dividend is paid. The United States government grants a foreign tax credit for the Canadian tax paid on profits plus the

Canadian withholding tax on dividends crossing the border. Also, the United States government recomputes the income of the Canadian subsidiary, using United States tax rules, for purposes of measuring the amount of United States tax due on the remitted dividend. Assuming a tax reducing depreciation rate of 50 per cent in Canada and a depreciation rate of 25 per cent in the United States, the parent company is able to claim only 25 per cent depreciation on the profits remitted by the Canadian subsidiary. The United States government in essence levies a tax that is approximately equal to the Canadian tax saved. Thus there results a shift from the Canadian to the United States treasury with no real benefit to business operating in Canada. The actual mechanics of the United States tax system and its foreign tax credit rules are more complex than this, but the example outlines the principle.

From our experience, however, we doubt that there is a very serious leakage in Canadian tax revenues in this way. If a foreign-owned business in Canada derives some benefit from a tax incentive, that business will likely try to avoid passing that saving on to its own domestic taxing authority. Hence, if remitting income to the United States means incurring additional United States tax, the firm will consider this factor in deciding whether or not to repatriate funds.

Occasionally, we see examples of subsidiaries who are eligible for fast depreciation writeoffs but who are directed by the United States parent not to claim those incentives in a particular year in order to keep the Canadian tax rate high. This may be useful in a particular year when dividends from Canada are going back to the United States at the same time that profits are being repatriated from another country where the tax rates are lower. This phenomenon is probably restricted to fast depreciation writeoffs because these deductions can be carried over to future years. On the whole, then, we do not think that there are significant shifts of funds from Canadian to foreign treasuries as a result of incentives.

Do banks assess new projects net of government assistance?

Although generalization in this area is difficult, the (existence of government incentives does not normally alter bankers' decisions to finance a project nor change the lending rate very significantly), especially for automatic or indirect incentives. As for grants or government loans, we feel that the reverse may be true. The security position of a bank can sometimes be increased when its client receives a significant grant or subordinated loan. That in turn may enable the bank to reduce the cost of borrowing slightly or to ease the repayment terms, to agree to further financing for working capital, or to take other similar actions.

Do incentives stimulate modernization rather than expansion in production capacity?

As discussed in several places in this paper, we believe that short-term investment incentives are indeed more effective in stimulating modernization of existing facilities. To effect the more substantive investments in new plant and equipment, the incentives have to be larger and longer in term.

Are government loans really last resort financing?

We believe that government assistance is neither initial nor last resort financing. Looking first at the smaller businessman, we find that he begins the search for funds for some new investment with his own personal resources or those of friends and acquaintances, then checks with his local bank (usually the principal source of financing.), and later turns to government assistance, finance companies, important manufacturers or customers, and other sources. The above sequence places government assistance after, but not too long after, the vist to the bank, as many small businessmen learn about government assistance from that source.

Turning to larger businesses, we learn that the important aspects of the investment decision are usually settled before government bodies are approached for assistance. Many larger businessmen, however, especially those familiar with assistance programs, may throughout the investment decision process anticipate receiving a certain amount of assistance. For example, the amount of DREE assistance can be estimated in most cases by using a formula. Some larger businesses may simply plug that into their feasibility studies for projects in slow growth areas without first talking to DREE.

Is there a lack of capital available?

We do not profess to know the answer to this perplexing question, for it almost depends on one's view of the type of projects that should go ahead. We rarely see examples of medium-sized or large businesses that cannot find a creditor to back new or expanded facilities. There may often be disputes over interest rates, but if the company has established banking relations, it normally gets its money at bearable interest rates. Very small or beginning companies may be turned down for reasonably priced capital because of poor financial data available, weak management, or lack of tangible assets to pledge as security. Neither banks nor government agencies like to lend money to a new business or to make equity investments for working capital in a new business. Small businesses that get help in preparing financial feasibility studies beforehand may have an easier time getting financing.

We applaud recent efforts by Ontario and Quebec to create financial intermediaries to funnel risk capital to small businesses. The Small Business Development Corporation of Ontario, however, may not pass the attention threshold test. The people who are most likely to invest in SBDCs are probably the same ones who are looking for tax shelters and, as a tax shelter, SBDCs do not compete very well. If people could invest directly in a small business, as in the Quebec program, they could pick companies where they feel they know the management. They would need less incentive to invest directly than to buy shares in an SBDC where the managements of either the group or its individual businesses are unknown.

We encourage the federal government to take more initiatives in this area. We also applaud its very recent announcement to create a form of insurance against losses on loans to smaller businesses in an attempt to channel to small businesses some of the vast sums in insurance companies, pension funds, and so on.

6 Summary

This paper about the effectiveness of government incentives is written from the viewpoint of the businessman and is based on our experience with how different businessmen actually react to the various types of government incentives. The paper is thus largely subjective in nature.

We believe that most incentives when judged individually have not been as effective in causing new investment in productive facilities as they were intended to be. However, the degree of success or failure of incentives varies with the type of incentive, the type of business and with different aspects of the investment decision.

Although we feel there are a few incentives which have actually caused the decision to invest, we believe most incentives should be viewed as attempts to remove one or more barriers that stand in the way of otherwise feasible investment projects.

The timing of investments appears to be more responsive to incentives than any other aspect of the investment decision. The timing of replacement investment in particular appears to be capable of being altered by several months while the timing of new or expanded facilities is not as responsive to incentives. We feel that the timing of investments in larger businesses is altered more than it is in smaller businesses because the larger business has more replacement investment and a greater knowledge of availability of incentives.

The location of investment is also affected somewhat by incentives. We feel existing grants and loans often cause new investments to be relocated by up to 100 or 200 miles but shifts from one region of Canada to another would normally only be caused where the incentive paid for the majority of the total cost of the new investment.

We do not believe that most incentives have any measureable impact on the size or quality of productive facilities the businessman buys. Exceptions can of course exist where the incentive is a very high percentage of whatever the investment costs.

The reasons for the ineffectiveness of most incentives are many and varied, but a few deserve particular mention. Firstly, the size of most incentives is simply too small in relation to total project cost to be an important factor in the "invest - do not invest" decision.

A few incentives such as multiple unit residential buildings, oil and gas drilling funds, Canadian films, income bonds and term preferred shares have been large enough to actually cause investment to occur.

To be highly effective in causing new investment, incentives would have to be much larger in size and therefore probably few in number.

Secondly, the designers of most incentives appear to largely ignore the non-financial causes and barriers to new investment. We belive that there are several important causes or barriers which might be called personal, emotional or even sometimes irrational. We feel these non-financial factors are frequently the predominant force in decision making and too often the financial incentives appear to have little or no softening effect on these other factors. Those who design and comment on incentives appear to make mechanical assumptions of the following kind: "a 10 per cent reduction in the cost of productive facilities to a businessman should cause him to increase his investments by 10 per cent". This ignores the very important human elements in decision making. For example, paying for the first 20 per cent of a businessman's investments may not alter his behaviour at all, whereas paying for the next 10 per cent may have a disproportionate impact on the investments he will make.

Thirdly, there continues to be an important knowledge gap about the existence and magnitude of government incentives, especially amongst medium and smaller businesses. We believe that the propensity of governments to frequently change not only the names and mechanics of programs, but also their disbursing agencies, is one important reason why the education gap continues.

Fourthly, the high cost of borrowed funds appears to be the most significant financial barrier to new investment in productive facilities. The government might consider the re-introduction of income debentures, term-preferred shares, or tax oriented leasing rules to more directly deal with this problem. Income debentures and term-preferred shares might be permitted only when used to finance new investments. We suspect such an incentive may be more effective than the combined effect of the existing investment tax credit and the fast writeoff for manufacturing machinery and equipment.

The paper discusses several other factors which tend to weaken the effectiveness of many incentives and they also can be important in particular situations. For example, risk of government policies changing, the short-term nature of some incentives, delay in passing enabling legislation, and the unwillingness of most government agencies to be lenders of first resort to some small or start up situations, all have a negative impact on the effectiveness of incentives.

The effects of incentives of various kinds differs by type of business. Smaller businesses seem to respond better to direct discretionary incentives than they do to automatic ones. We feel the opposite may be true in medium and larger businesses. Smaller businesses also seem to be responsive only to up-front financing assistance whereas larger or more profitable businesses react to both those as well as cashflow type incentives. As most investment is made by larger businesses, we believe that the more permanent and automatic incentives are probably more important micro-economic tools than the short-term or discretionary incentives. The lack of knowedge about incentives amongst smaller businesses might be alleviated a little if governments would direct their information campaigns to those who traditionally advise small businessmen as well as to the businessman himself. The apparent lack of reasonably priced capital for the very small or start up situations, might be alleviated a little if the government funded financing proposals or adopted the type of incentives recently proposed by Ontario and Quebec for smaller businesses.

Firms which have low taxable profits (perhaps due to loss-carry forwards from recent difficult times or because they are earning rapid tax depreciation from new investments) frequently have difficulty getting rapid benefit from incentives which can not be received until the company is paying tax (eg., investment tax credit, or fast write off for certain machinery and equipment). A contingent incentive is often totally ignored by the investor in his decision making.

The foreign businessman, we feel, has important additional barriers to investment in Canada. Many of these are more psychological than financial, and the mere existence of the Foreign Investment Review Agency is probably the most-cited example. We believe it would be very informative to study more closely the investment criteria of foreign-owned companies versus Canadian-owned ones.

In several places in this paper we have spoken in a rather negative manner about the effectiveness of individual government incentives. We should point out that although they fail analysis in their own right, they may still prove to be a worthwhile element of an overall financial package available to investors in Canada. It is extremely important that the overall investment climate in Canada be made to look as attractive or more attractive than that in the U.S., for it is the U.S. that Canada is most often compared to when businessmen make new investment decisions.

We believe that Canada has some inherent competitive disadvantages in terms of the size and dispersion of its markets, and high costs of transportation, and therefore it is a greater challenge for the businessman to produce products in Canada which are sold internationally. For these reasons, we believe that government incentives have a role to play in maintaining a high level of investment in productive facilities in Canada. (While we conclude rather quickly that certain incentives such as the existing investment tax credit have little or no impact on investment by itself, it may in the minds of many prospective investors prevent Canada from appearing to have an important gap in its package of incentives. We are in a competitive world and governments of different countries have in the past competed with one another to attract new investment and new jobs and no doubt will continue to do so.)

We believe that Canada must achieve even greater sophistication in designing types of incentives which are both highly effective and yet not so noticeable on international markets as to attract countervailing duties. One of the reasons many Canadian businessmen had anxiety over the multi-national trade negotiation talks, is that they feared Canada would only effectively negotiate the bilateral removal of overt tariff barriers, without making sufficient headway with the important non-tariff incentives in other countries (eg., DISC's and leveraged lease financing in the U.S.).

Countries such as the U.S., the U.K. and Japan, have not hesitated to throw the full support of their governments behind assisting the financing of capital assets. This country needs even more effective investment incentives than these major competitors.

It is difficult to draw conclusions from a discussion of a subject so broad. The financial markets are complex and ever-changing and we believe that the government will have to continue to maintain a reasonably broad set of incentives to meet our diverse political, economic and social objectives. In this period of increasingly intensive international competition governments should assist the business and investment communities in their bid to expand, generate internal cash flow and seek higher profits, thereby producing greater growth and employment in Canada.