p.61

AN OVERVIEW OF SMALL BUSINESS FINANCING

A Report Of The
Small Business Financing Review Team
Department of Industry, Trade and Commerce

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CONTENTS

REPORT

SMALL BUSINESS FINANCING REVIEW

CAVEAT

This report summarizes the various studies conducted under the auspices of the small business financing review. While the reported results have, in most cases, been taken directly from the studies, they have been selected on the basis of policy relevance and may not reflect the entire study results. The interpretation given to the results of the studies is the sole responsibility of the review team and does not necessarily reflect the views of the Department of Industry, Trade and Commerce nor that of the authors of the various studies.

WHY A REVIEW

The review was undertaken in response to the federal government's concern about the adequacy with which the financing needs of smaller businesses were being met by private sector financial institutions and government assistance measures. This concern is not new. The Industrial Development Bank was founded in 1944 to help businesses obtain longer term loans. In 1975, reflecting a growing awareness of small business as a unique community and in response to changing conditions in capital markets, the Federal Business Development Bank (FBDB) was established to replace the IDB. At that time, its mission was modified to provide a greater emphasis on the needs of smaller businesses.

Similarly, the Enterprise Development Program (EDP) was launched in 1977 to provide, in addition to contributions, a guarantee facility to enable smaller businesses to obtain term loans. The Small Businesses Loans Act was amended in 1978 to enable lenders to provide term loans at a competitive interest rate of chartered bank prime rate plus one percent. To further encourage term loans, the government introduced the Small Business Development Bond in December 1980. This measure enabled lenders to pass income tax savings to smaller businesses in the form of lower interest rates on term loans. As an additional impetus, the government introduced, in 1980, a measure (Credit Re-Insurance) to provide insurance to lenders to enable them to borrow from pension funds, trust and life insurance companies and make term loans to businesses. Throughout the seventies, changes were also made to the Income Tax Act to enable smaller businesses to retain a greater portion of their profit for use in developing their businesses.

Regional Economic Expansion (DREE) has been involved in program support for small business since its inception in 1969 through a variety of development agreements with the provinces and territories, a number of financial incentive programs, and Special Area Programs. They provide grants and loan guarantees to businesses (including small business) who seek to expand, modernize or establish new manufacturing or processing facilities in certain designated areas across Canada. The level of incentive may differ from area to area depending on the type of designation. Special Area designation provides a more comprehensive and an enriched program of incentives. On the Magdalen Islands Special Area, for example, small and medium-sized businesses in manufacturing and some primary and service industries are eligible for incentives of up to 50% of approved capital costs.

In regions designated by DREE, enhanced levels of tax credits are available through the Special Investment Tax Credit Program. Depending on the type of industry and its location, tax credits of up to 50% of the cost of manufacturing investments may be claimed.

Small businesses also benefit from the contributions made under various Industry, Trade and Commerce programs to encourage innovation and develop exports. The contributions can serve as additional equity and enable firms to finance riskier projects. The review, however, did not address the impact of such contributions on small business financing.

As an indication of the magnitude of support, during the fiscal year ended March 31, 1981 the Government of Canada provided direct and indirect financial assistance to small business as follows:

	$millions
Direct term loans:	
Federal Business Development Bank (FBDB)	336
Guaranteed Loans	
Small Businesses Loans Act (SBLA)	408
Enterprise Development Program (EDP)	36
Low interest bonds:	
The Small Business Development Bond (SBDB)	
(December 1980 to March 31, 1981)	200
Equity Investments (FBDB)	14
Small Business Tax Deduction	1000
Other Tax Measures	346
Contributions (All Departments)	371

The cost of these measures in terms of direct outlay or foregone revenue is estimated at $1.8 billion and is expected to increase by at least $80 million prior to March 31, 1982 due to the volume of small business development bonds issued from April 1, 1981 to January 31, 1982.

The provinces too were active in this area and together provided assistance in the form of loans ($477 million) and grants ($164 million) as well as tax incentives.

Despite these measures, concern as to the adequacy (interest rate, length of term, amount, loan conditions, type of capital) of the flow of funds to small businesses persisted. To this was added a concern as to whether these measures complemented each other, reflected changing conditions in capital markets and economic circumstances, and, taken together enabled smaller businesses to grow and develop profitably and thereby realize their full potential in contributing to the growth and development of the Canadian economy.

The purpose of the small business financing review was, therefore, to examine the adequacy with which the combination of private sector financial institutions and federal government measures and institutions meet the financing needs of small business and, in light of the available evidence, suggest ways and means by which the government might better align and coordinate its measures and institutions to meet the changing needs of small business and changing conditions in capital markets.

THE PURPOSE OF THIS REPORT

With many groups, each with a substantial interest in the outcome of public policy decisions which affect the financing of small business, there are likely to be differences of opinion as to what the major issues are and what priority should be attached to them. Perhaps of even greater importance is the likelihood that the perception as to what can and should be done about the issues is likely to be different depending on the interests of the parties, the information available to them and the interpretation placed on that information.

Because policy decisions must be implemented through the organizations which are participating in the review, their view of the issues and the practicality of alternatives or potential solutions to the problems contained in the issues is important. "The practicality of the solution often depends on the willingness and ability of organizations which are charged with its implementation." In this sense, options can define issues and it becomes even more important that the expertise and point of view of the study participants be brought to bear on the issues.

With these considerations in mind, it is important that a measure of agreement be reached among the interested parties as to what are the major issues, relevant facts and practical alternatives. This requires discussion and a sharing of information. Accordingly, the purpose of this report is to summarize and disseminate the results of the studies conducted under the auspices of the small business financing review.

ANALYTICAL FRAMEWORK: THE ISSUES

The Logic of the Intervention Process

The fundamental issue addressed by the small business financing review is whether the financing needs of small and medium-size businesses are being adequately met by private sector financial institutions and government assistance programs. Financing needs can be defined in terms of the availability and cost of working capital, term debt and venture capital required to establish and profitably develop an enterprise. Adequacy can be assessed in terms of discerned financing needs, prices and terms available to larger size businesses and government objectives regarding small business.

Many of the government's financing assistance measures are predicated on the belief that there are gaps in financial markets -- gaps in the sense that the flow of funds to small businesses is impeded or restricted because of the rate of interest charged, security demanded, length of time to repay or the amount granted, as opposed to the amount requested. Such gaps are thought to be caused by a number of factors: high default risk, administrative costs per dollar of loan, lack of competition, poor organization, lack of knowledge. The presence of such gaps is thought to impede the growth and development of smaller firms. By remedying these financial market imperfections, government measures enhance the growth of smaller businesses and this contributes to the achievement of broader policy objectives: economic development, social and political goals. In assessing the effectiveness of government assistance measures it is essential to take a closer look at this chain of cause and effect relationships which stretches from the intervention instrument through capital markets to small business and hence to policy goals.

Weak Links in the Logic Chain

Gaps in Financial Markets

One of the more critical links is the existence, causes and consequences of gaps in financial markets. The existence of a gap is often demonstrated in terms of borrowers who were unable to get the desired funds or did not like the terms and conditions attached. The problem here is that there will always be gaps and these may be beneficial as well as harmful. Credit is, from the lender's point of view, as much an art as a science. Character assessments must be made and judgements rendered. From the standpoint of borrowers, there will always be a shortage of zero priced funds that never have to be repaid. Interest rates will always be too high, the term too short and the security demanded excessive. At the same time, from the perspective of a lender or investor, there will always be a shortage of profitable opportunities to place debt or equity capital.

From the government's point of view, gaps can be a mixed blessing. To the extent that unsatisfied demand represents a rationing of funds to inefficient firms then economic performance is improved. If, however, the rationing retards the development of firms during the rapid growth phase of their life cycle and these firms are in sectors which the government wishes to encourage, then the gap is a cause of concern. Similarly, if the gaps inhibit research and development, innovation, export development or encourage concentration or foreign ownership, then government cannot be indifferent to their existence.

Identifying relevant gaps, assessing the impact on small business and estimating economic or social consequences requires information. Do financial institutions in fact discriminate on the basis of the size of the transaction or the size of the business? What size? Where? Why? If so, is this "bad" or "good"? If "bad" how can it be remedied? To answer these questions, others must be asked. What are the financing needs of small business measured in terms of working capital, term debt and equity capital? Are these needs, somehow determined, realistic? Why are these needs not now being met by private sector institutions? Are government intervention measures (tax, regulations, programs, institutions) correcting the discerned gaps? Creating them? Displacing private sector activity? Having no effect? What measures, if any, need to be changed? Why? How much will it cost? What will be achieved?

While an analysis of demand should shed some light on what small business thinks the gaps are, it will not explain why they exist, how long they will endure, nor what is needed to remedy them. For this, what is needed is an understanding of the factors which govern the supply of funds. These supply issues include the factors which determine the cost of funds, transaction costs, risk, market niche and competitive position. Specifically, the issues are the effect on the supply of funds of:regulation, tax measures, institutional characteristics, the major trends in the economy which affect savings and investment, government (federal and provincial) programs and institutions.

The information developed in the course of the review regarding demand and supply conditions should lead to a clearer understanding of the areas where the financing needs of small business are not being met, why they are not being met and what is required to close the gap. This should permit a better identification of the intermediate targets of government intervention measures. Comparing these targets with those actually being hit by government measures should permit some judgement to be made regarding one facet of the effectiveness of government assistance measures.

The Objectives of Small Business Policy

The identification of gaps may afford some idea of where the government may wish to intervene in capital markets but does not fully answer the question of what it hopes to achieve through intervention. What objectives will be better served? Less well served? What are the government's objectives regarding small business? Economic? Social? Political? All three? What will be achieved by intervening in capital markets? How are the results of intervention linked to government objectives?

One of the frequently cited objectives of government policy is to enhance the contribution of small business to economic objectives: employment creation, exports, import substitution, innovation, regional development, productive efficiency. If these are the ultimate objectives of public policy then it is important from an effectiveness perspective to establish, theoretically and empirically, the cause and effect linkages between incremental contributions to these objectives, the sub-sector of the industrial structure designated as small and the remedying of real or perceived gaps in financial markets.

It is sometimes suggested that the rationale for intervention is not economic but social. Disregarding the fact that there are economic impacts whether they are acknowledged or not, the social argument is that small businesses are a desirable "good" in their own right -- more of them are preferred to less. Restating this argument in terms of a public good, it is quite conceivable that qualities generally attributed to small business are valued by society and hence desirable in and of themselves. As a matter of social policy, government may wish to foster and encourage entrepreneurship, competition, self-reliance, preservation of "pioneer" values.

If this is the reason why the government wants to assist small business then the same linkage considerations apply as in the case of economic performance. The clusters of firms which are most likely to produce these social goods should be identified by size and sector in order to direct assistance measures. Additionally, economic impacts of such actions should be clearly recognized because it is possible that the government's rationale for intervention is a mixture of both economic and social factors.

Policy Relevant Clusters of Small Businesses

Small business consists of some 200,000 to more than 1,000,000 entities, depending on the definition used. These entities are found in most industrial sectors and are distributed throughout the regions of Canada in numbers that are proportional to provincial populations. Many government programs designed to assist the small business community establish some more or less arbitrary level of sales, assets or employment as an upper limit for eligibility. Everything below that level is considered to be "small", everything above is presumably considered to be "big". Statistics are also gathered regarding number of firms, contribution to Gross National Product, employment, and so forth. These, too, are subject to some arbitrary definition of size. The number of firms and their relative contribution to economic goals depends very much on the size level selected.

Since there is no explicit or implicit rationale for selecting any given level of sales, assets or employment, one level would appear to be just as valid as another. This permits a great deal of flexibility in the choice of definitions and tends to create some confusion as to just what is meant by "small business".

Arbitrary, universal definitions also tend to introduce distortions between sectors. For example, selecting an annual sales level of $1 million as the upper limit of what constitutes "small" business means one thing in the retail sector, where the dollar volume of sales may be high, but the value added by the sector is small and quite another in the service sector -- automotive servicing, for example -- where sales volume is comparatively low but the value added relatively high. The size of firms, relative to each other and their importance in the sector, is likely to be quite different.

Coupled with the difficulties introduced by the use of arbitrary definitions which try to establish what constitutes "small", are those which could arise because of the assumption that all those firms below the chosen level are the same: that is, the small business community so described is homogeneous. This suggests that, for policy purposes, a typical firm can be selected to represent the community. A model firm can then be structured, endowed with relevant attributes, and used as the implicit target and/or the rationale for the prescribed measures.

With no way to ascertain just how representative the model firm might be, the policy analyst can exercise considerable discretion in selecting the attributes with which to endow the model. While convenient, this flexibility tends to reduce analysis to a comparison of hypothetical cases buttressed by selective (and perhaps misleading) statistics.

To speak of the financing needs - working capital, term debt and venture capital - of small business as though all those entities covered by a particular size definition had common attributes, and hence common financing requirements, is to ignore reality. Capital requirements are known to vary according to many factors: the stage of development (start-up, rapid expansion, mature, declining); the nature of the sector in which a business is operating; conditions in the sector (excess capacity, stagnant demand, foreign competition, changing tastes). Capital supply conditions are known to vary as well, depending on a number of factors: size of transaction; nature of the assets; track record of the entity; location of the firm; the character, capacity and capital of the entrepreneur.

What is needed is a division of the business community into policy relevant clusters: groupings which divide small and large enterprises on the basis of financing issues, economic and social objectives and permit the establishment of cause and effect relationships between the clusters, the intervention measures and policy goals.

THE SMALL BUSINESS COMMUNITY: A PROFILE

As a first step toward a better understanding of the nature of small business, the review commissioned, in September, 1980, an analysis of data derived by Statistics Canada from income tax returns. The results of this analysis together with a description of the data sources and methodologies employed are outlined in detail in a paper entitled "A Profile of Small Business in Canada" by Edward Hughes, James Whipp and J.R. D'Cruz. What follows is a brief summary.

Major Clusters

Based on 1977 income tax returns, there were some 1,127,000 entities in Canada which had an income that was not derived from wages and salaries or which reported business income. Among these are many groups which are not usually regarded as part of the population to which small business financing measures are directed. Not that their financing needs and welfare are not of concern, only that these needs are addressed in a manner which differs from that of ordinary business. Farmers and fishermen, for example, are groups whose financing and other needs are the subject of special policy measures and institutions. Government-owned enterprises, welfare and other non-profit organizations can also be excluded on the grounds that financing needs are met in a manner which differs from that of ordinary business. Similar considerations can be applied to financial corporations, commission salesmen and self-employed professional people. Excluding these groups reduces the relevant population of business entities to approximately 528,000.

Large-Scale Enterprises

Within this population there are a number of firms with linked ownership and a management and control process which operates the entire enterprise as a unified business entity, moving resources back and forth between firms to suit a particular corporate strategy. The basic unit is, therefore, the enterprise group and not the individual firms which make up the group. Financial institutions tend to treat the enterprise as the basic unit in providing financial services and assessing credit worthiness. Each chartered bank has a "corporate client service group" which services the larger of these enterprises. The corporations thus distinguished are the 1,100 largest in Canada.

Treating the enterprise as the basic unit, the affiliates of these corporations and the subsidiaries of large foreign corporations can be regarded as being part of the large-scale enterprise group. In total, this group consists of 8,100 firms and they account for 58% of the sales of the indentified population of business entities.

Self-Employment Firms

After removing the large scale enterprises, the remaining 520,000 entities constitute the population of small businesses. Of these, there is a group consisting of 295,000 entities which have annual sales of less than $100,000 indicating that they likely provide employment only to the owner. In total these entities account for 3 percent of "business" sales. Most (77%) are unincorporated.

In the self-employment firm, the distinction between the income, equity and liabilities of the owner and the business is often difficult to make. In fact, most financial institutions in their dealings with self-employment firms, act as though the distinction does not exist. When the owner of a "mom and pop" grocery store or a single-vehicle taxi company seeks a loan for business purposes, the financial institution will look at the owner's personal credit history for evidence of probity, as much as at the credit track record of the business, and will take into consideration, for collateral purposes, the owner's personal net worth as much as that of unencumbered assets of the business. Thus the access of a self-employment business to financial resources is as much a function of the non-businesses financial history and position of the owner as it is of comparable characteristics of the business itself.

While the contribution of self-employment firms to "business" activity may be small, the concerns of government with respect to this group may be more on the side of social values than on a quantitative contribution to economic development. These entities differ from others in that most are unincorporated. This means that business income is taxed as personal income, business assets and liabilities are inseparable from personal assets and liabilities. They are, in reality, wage earners who have elected to incur additional risks for the sake of "being on their own". Not only do they incur additional financial and business risks to earn a living, they are not covered by unemployment insurance and workmen's compensation. Neither do they benefit from company sponsored pension plans as do most other wage earners.

The willingness and ability to bear risk for the sake of being independent and letting the market determine income is often regarded as the hallmark of entrepreneurship. The group of self-employment entities certainly exemplifies this characteristic. The government could regard entrepreneurship as a desirable social goal, in and of itself, and wish to structure measures which would foster and enhance its growth. For this reason, the group of self-employment firms constitutes an important policy target.

On purely statistical grounds, including the unincorporated self-employment firms in the data gives rise to serious problems of interpretability: wage and salary income cannot be segregated from profits, personal assets cannot be distinguished from business assets, tax rates are different, and so on.

Canadian-owned, Independent Firms

The remaining cluster consists of 225,000 Canadian-owned, independent (not affiliated with a large scale enterprise) firms, most (64%) of which are incorporated. These firms have annual sales in excess of $100,000 but less than $30 million and account for 39 percent of "business" sales. The incorporated firms also account for 88 percent of total group sales. While $30 million represents the maximum size of firm in this group, there are very few firms in this category. There is also a considerable difference in the size of the largest firm, ranging from $2 million in one sector up to $30 million in another.

It may be useful to point out that while small and medium size businesses in this category are independent of large scale enterprise groups in terms of equity linkages and management control in the administrative sense, some of them may operate with quasi integration linkages with similar impact on resource availability and access to finance. Thus, for example, franchise arrangements, long term supply contracts, distribution and other arrangements that create a linkage between an "independent" small business and a particular large scale enterprise may confer benefits on the business similar to those which accrue to subsidiaries in enterprise groups. Such benefits could include access to technology, use of a well advertised brand name, managerial knowhow and training. In return, the business may be required to agree to limit its freedom of action regarding the market areas, the nature of operations, and scope of product line. Thus, quasi integration linkages may place substantial limits on the degree of independence of the firms in question.

Apart from the impact of these linkages, firms in this category are generally limited in resources to those which are internally available or those which can be purchased from the open market. Thus, resource availability is co-extensive with the individual firm and not conditioned by linkage to a larger enterprise structure. It is to be expected, therefore, that such firms will be treated by the financial markets on the basis of their own (or their owner's) financial position and performance. On the other hand, when quasi integration linkages are significant to the firm's success, financial institutions are known to take these linkages into account in making decisions about providing funds. Canadian Chartered Banks, for example, offer special financial packages to holders of well known fast food franchises.

Adjusting for Inflation

The size ranges used in this report are expressed in 1977 dollars. A rough approximation of what the cell sizes mean in terms of 1981 dollars can be obtained by multiplying by 1.4 -- the compounded inflation factor. Determining the number of firms in each "new" size category would require the profile to be recalculated on 1981 data since some firms may not have kept up to the rate of inflation in sales growth. The expectation, however, is that, on average, growth rates paced inflation.

The Industrial Sectors Where the Major Groups Are Located

The percentage of total sector sales accounted for by each size class was calculated for each of 200 three digit SIC classifications. Only the salient results are reported here. Complete results are available on request from the authors of the "Profile" study.

While the leading 1,100 enterprises dominate business activity in general, the degree of domination varies significantly across industrial sectors. As indicated in Table 1 some industries - such as steelmaking, chemicals, transportation and communication equipment - are completely dominated by large enterprises. In other sectors - clothing, publishing, radio and TV broadcasting, for example - their subsidiaries or affiliates account for a large percentage of the activity.

Table 1

Sectors Where Large Firms Account for a Major Proportion of Industry Sales

Industry	% of Sector Sales
Motor Vehicle, Truck Body & Trailer Manufacturers	95.7
Misc. Communication and Utilieies	91.3
Iron & Steel Mill, Smelting & Refining	90.5
Misc. Chemical & Petroleum Industry	88.0
Water, Rail & Pipe Line Transportation	86.0
Crude Petroleum and Natural Gas	85.0
Communications Equipment Manufacturers	82.9
Metal & Non-metal Mines	82.1
Misc. Food Industry	80.3
Misc. Manufacturing Industries (N.E.S.)	80.0

Sectors where 'Affiliates' Account for a Major Proportion of Industry Sales

Industry	% of Sector Sales
Misc. Clothing Industry	88.1
Publishing Only	46.0
Radio & Television Broadcasting	41.2
Sporting Goods & Toy Industries	39.0

The sectors where the Canadian-owned, independent firms dominate activity are shown in Table 2. This group also tends to cluster heavily in certain sectors. As shown in Table 3, 65% of these firms are found in just 14 industrial sectors.

The self-employment entities also tend to concentrate in few sectors with some 72% found in 16 sectors (Table 4). As shown in Table 5, there is a considerable overlap between the sectors where self-employment and independent firms are concentrated. Over half of both groups are found in the same nine sectors.

In the sectors where the "independents" tend to congregate, the retail trades account for 51% of the population and construction 30%. Similarly, in the sectors where the "self-employed" entities congregate, the retail trades account for 37% of the population, construction 27% and truck transport 14%.

Table 2

Sectors Where "Independents" Account for a Major Proportion of Industry Sales

Industry	"Independents" Sales as % of Sector Sales	Number of Independent Firms
Tire, battery & accessories stores	91.9	2,233
Motor vehicle repair	91.7	7,981
Machine shops	88.4	1,032
Motor vehicle dealers	86.9	4,841
Clothing industry	85.9	1,382
Gasoline service stations	85.5	10,420
Special trade contractors	84.2	33,078
Drug stores	81.2	3,077
Hosiery & knitting mills	80.9	230
Building construction	80.7	10,662
Retail stores, Not Elsewhere Specified	79.5	8,890
Misc. personal services	79.3	1,165
Blacksmithing & welding shops	78.1	865
Photographic services, Not Elsewhere Specified	76.6	912
Miscellaneous repair shops	76.5	631
Household furniture & appliance stores	75.9	7,756
Wholesalers of scrap and waste materials	75.6	639
Signs & displays industry	75.3	280
Advertising services	73.9	1,062
Radio, television, & electrical appliances repair stores	73.2	555
Florists' shops	73.2	749
Men's clothing stores & custom tailer shops	72.8	1,522
Household furniture manufacturers	72.0	874
Women's clothing stores	71.9	2,106

Table 3

Sectors with Substantial Numbers of Independent Businesses

Rank	Industry	Number of Firms	Cumulative Percent
1	Special Trade Contractors	33,078	14.7
2	Hotels, Motels, Restaurants	15,299	21.5
3	Food Stores	14,730	28.0
4	Building Construction	10,662	32.8
5	Gasoline Service Stations	10,420	37.4
6	Wholesalers, Not Elsewhere Specified	8,985	41.4
7	Miscellaneous Service to Business Management	8,892	45.3
8	Retail Stores, Not Elsewhere Specified	8,890	49.3
9	Motor Vehicle Repair Shops	7,981	52.8
10	Household Furniture and Appliance Shops	7,756	56.3
11	Truck Transport	5,968	58.9
12	Motor Vehicle Dealers	4,841	61.1
13	General Merchandise Stores	4,426	63.0
14	Wholesalers of Machinery & Equipment not Elsewhere Specified	3,948	64.8
	Sub-Total	145,876	64.8
	All Remaining	79,333	100.0%
	Grand Total	225,215	

Table 4

Sectors Where Self-employment Firms are Concentrated

Rank	Industry	Number of firms	% unincorporated	Cumulative % of Total
1	Special Trade Contractors	42,384	91	14.4
2	Truck Transport	30,049	91	24.5
3	Hotel, Motel, Rest. etc.	23,959	78	32.7
4	Wholesalers, N.E.S.	16,382	60	38.2
5	Retail Stores, N.E.S.	14,140	74	43.0
6	Misc. services to business	11,388	35	46.9
7	Food Stores	10,582	90	50.4
8	Barber & Beauty Shops	9,246	96	53.6
9	Misc. Services N.E.S.	8,469	58	56.4
10	Building Construction	8,039	38	59.2
11	Taxicab	7,989	97	61.9
12	Amusement & Recreation services	7,779	65	64.5
13	Other construction	6,359	94	66.7
14	Logging	6,228	87	68.8
15	Motor Vehicle Repair	5,275	91	70.6
16	Service to Buildings	4,504	90	72.1
	Sub-Total	212,772		
	All Remaining	82,396		
	Self-Employment Total	295,168		

Table 5

Sectors Where Self-Employment and Independents Are Concentrated

Rank	Industry	Self-Employment Firms	Independents	Combined
1	Special Trade Contractors	42,384	33,078	75,462
2	Hotels, Motels, Restaurants	23,959	15,299	39,258
3	Truck Transport	30,049	5,968	36,017
4	Wholesalers (Not Elsewhere Specified, N.E.S.)	16,382	8,985	25,367
5	Food Stores	10,582	14,730	25,312
6	Retail Stores N.E.S.	14,140	8,890	23,030
7	Miscellaneous Service to Business	11,388	8,892	20,280
8	Building Construction	8,039	10,662	18,701
9	Motor Vehicle Repair	5,275	7,981	13,256
		162,198	114,485	276,683
	Percentage of Total Firms	55%	51%	53%

Distribution of Sales Activity by Firm Size

An examination of the distribution of sales by firm size for the SBFR universe of 528,000 firms indicates that over 95% of all firms had annual sales of less than $2 million. Fully 60% had sales of less than $50,000.

Sales activity is heavily concentrated by firm size: one percent of the firms account for 60% of total sales. Three quarters of all firms have annual sales of less than $200,000 and, in total, these firms account for 6.5% of total sales.

The distribution of sales activity by firm size was calculated on an industry basis for the "independent" group of firms. This indicated that while sales activity tends to be concentrated in the larger firms in each sector, the degree of concentration varied from sector to sector. In the 14 sectors where 65% of the independents are found, some 13% of the firms account for 50% of total sales.

Arranging the "independents" in ascending order of sales size for each industry sector and then comparing the average size of firm in each sales quadrant (the firms in the first quadrant account for 25% of total sector sales) indicated that there are significant intersectoral differences in firm size. Firms accounting for half the sales in the Hotels, Motels, Restaurants sector, for example, had annual sales of less than $443,000. Those in the Motor Vehicle Sector, by way of comparison, had sales of less than $5.4 million.

Smaller Firms Are in a Different Type of Business

Most small firms are in a fundamentally different business than larger firms. The bulk (53%) of small firms by number are found in nine sectors. In these sectors, most (83%) are found in retail trades (36%), construction (34%), and truck transport (13%). In construction, the special trade contractors are the largest group, comprising 80% of construction firms. Most small businesses(64%) in the retail trade group, are in the hotel, motel and restaurant business (39%) or in the foodstore business (25%).

With the exception of food stores, these are not sectors where larger firms dominate activity. In the special trade contractors' sector, small, independent (sales greater than $100,000 but less than $30 million) firms account for 84% of activity; in hotels, motels, and restaurants 68%; in truck transport 55%. The same is true for the other sectors in which small firms congregate: building construction 81%; gasoline service stations 86%; motor vehicle repair shops 92%; motor vehicle dealers 87%; and so on. In general, both the sectors where small businesses congregate by number or where they dominate sector activity are not the sectors where the larger firms are found -- i.e., they are in basically different lines of business.

Financial Characteristics

The Small Business "Core"

Most published statistics regarding the financial characteristics of small business can be very misleading, especially when annual sales volume is used as the measure of size. This is due to the fact that the smaller size classes are statistical "maternity wards" and "mortuaries". Firms in a start-up situation, for example, will have no or very low sales the first year but could have assets in excess of $10 million. The first year of operation will see them classified as a very small firm (sales of less than $100,000) while ensuing years will see them classed as a large firm as sales volume comes into balance with assets.

The same is true of exiting firms. Before exiting, these firms have negative profit, negative net worth and low or no sales and hence are classified in the smaller sales size classes. Many such firms were previously observed in larger size classes. Ignoring this phenomenon makes the statistics on smaller size classes virtually uninterpretable -- especially where the statistic used is the mean of distribution.

Therefore, business firms which are in a state of transition - start-up, turnaround, exit - need to be separated from those which are not before analysis of financial data can be meaningful. Three categories of transition firms were established, roughly corresponding to the three states of transition listed above. This should not be taken to mean that firms in a state of transition do not matter or can be disregarded from the point of view of public policy. It means only that in order to estimate financial relationships which describe the majority of firms, the special groups must be segregated.

Those firms with negative or marginal equity and negative profit were classed as Type I, this class serving as a rough proxy for that segment of the population which is in the process of exiting from the industry. Those with a negative equity but positive profit were classed as

Type II firms and regarded as being in a turn-around situation. Those with a substantial positive equity relative to assets but a low percentage of sales to assets were classed as Type III and roughly approximate a start-up situation. The balance of the firms were classed as "normal" firms that are more established. Table 6 shows the overall results when the performance classes are arranged by quartiles.

Each quartile contains 25 percent of the firms by number. The first quartile contains the smallest firms with annual sales up to $58,000. In this group 22 percent of the firms have both negative equity and negative profit and hence are classed as Type I. Another 28 percent of the firms have characteristics which reflect a start-up situation and around 7 percent are in a turn-around situation. Fully 56 percent of the smallest firms can be classed as being in a state of transition and, therefore, not "normal". As can be seen, the percentage of firms in either the "exiting" or "start-up" categories declines sharply as size increases. The main area where both phenomena play a major role appears to be limited to firms whose annual sales are less than $172,000. This also encompasses 50 percent of the incorporated, independent businesses in Canada, whose sales are less than $30 million.

Table 7 depicts the same phenomena but expresses the distribution in terms of the number of firms in each size and transition class as a percentage of all firms in the population of independent, incorporated firms. It shows that overall, only 24 percent of the population is composed of transition situations and 76% are hence "normal". Again, the special situations occur most frequently in the two smallest size classes.

Table 6

Transition Status by Size Class

All Sectors

Quartile	Size Range ($000 sales)	Transition Status: Type I	Type II	Type III	Total	Normal Status	Grand Total
		(Percent of Firms in Quartile)					
1	1 to 58	21.6	6.8	27.6	56.0	44.0	100.0
2	58 to 172	16.8	5.2	2.4	24.4	75.6	100.0
3	172 to 471	9.2	2.8	.4	12.4	87.6	100.0
4	471 to 28,831	3.6	0.8	0.0	4.4	95.6	100.0
Total, all firms		12.8	3.9	7.6	24.3	75.7	100.0

Table 7

Transition Status as a Percentage of All "Independent", Incorporated Firms

Quartile (no. of firms)	Size ($000 of sales)	Type I	Type II	Type III	Total Transition Status	"Normal Status"	Grand Total
		%	%	%	%	%	%
1	$1 - 58	5.4	1.7	6.9	14.0	11.0	25.0
2	$58 - 172	4.2	1.3	.6	6.1	18.9	25.0
3	$172 - 471	2.3	.7	.1	3.1	21.9	25.0
4	$471 - 28,831	.9	.2	0	1.1	23.9	25.0
		12.8	3.9	7.6	24.3	75.7	100.0

Segregation of the population by performance category also indicated significant inter-sectoral differences. The results of this analysis are available in a separate report for 107 industry classifications. By way of illustration, the 14 sectors where the majority of the 'independents' tend to congregate are depicted in Table 8

Table 8

Distribution of Firms By Transition Status

Sectors Where "Independents" Concentrate

	Transition Status Type I	Transition Status Type II	Transition Status Type III	Total Transition Status	Normal Status
	%	%	%	%	%
Special Trade Contractors	11.6	3.4	4.3	19.3	80.7
Hotel, Motels, Restaurants	18.6	6.0	13.9	38.5	61.5
Food Stores	11.4	2.7	8.3	22.4	77.6
Building Construction	14.7	3.3	8.3	26.5	73.5
Gasoline Service Stations	9.4	3.4	8.9	21.7	78.3
Wholesalers, NES*	13.4	4.9	7.6	25.9	74.1
Misc. Services to Business Management	11.3	5.6	8.7	25.7	74.4
Retail Stores NES	21.2	6.2	5.0	32.4	67.6
Motor Vehicle Repair Shops	11.8	3.4	4.8	24.0	76.0
Household Furniture & Appliance Shops	15.1	3.4	6.3	24.7	75.2
Truck Transport	12.8	5.5	5.2	23.5	76.5
Motor Vehicle Dealers	5.8	1.0	9.6	16.4	83.6
General Merchandise Stores	4.3	1.1	8.5	13.9	86.1
Wholesalers of Machinery and Equipment NES	13.4	3.9	7.1	24.4	75.6

* Not Elsewhere Specified

Some government policies are aimed at encouraging economic development in "sectors of opportunity" that have been singled out as having a potential for rapid growth. Data on one such sector, that of Communications Equipment Manufacturers, is provided in Table 9, which indicates the proportion of firms in the various transition classes. While 64 percent of all firms in this sector are classed as "normal",what stands out is the number of firms with a small volume of sales which are in a state of transition.

Table 9

Distribution of Transition Status by Quartile

Communications Equipment Manufacturers

Quartile	Size Range ($000 sales)	Transition Status: Type I (Percent of Firms in Quartile)	Type II	Type III	Total	Normal Status %	Grand Total %
1	1 to 70	34.4	6.8	34.4	75.6	24.4	100
2	71 to 240	34.4	6.8	0.0	41.2	58.8	100
3	241 to 941	14.0	14.0	0.0	28.0	72.0	100
4	942 to 1,310	0.0	0.0	0.0	0.0	100.0	100
Total, all firms		20.7	6.9	8.6	36.2	63.8	100
Total number of firms		174					

It is clear that the relationship between transition status and size is more pronounced in this sector of opportunity than it is in the sectors of concentration noted earlier in Table 8. On the one hand, three quarters of the firms in the smallest size range are in some sort of transition status and only 24 percent are "normal". On the other hand, none of the firms in the largest size class appear to be in a transition status.

Financial Relationships

With the population of incorporated firms partitioned by performance characteristics, the portion not characterized by special situations (exiting, start-up, turn-around) - that is, the 'normal' firms - was analyzed to estimate four different financial relationships. These were the relationship of assets to sales, debt to assets, profit to sales, and profit to assets.

In general it was found that use of the conditional mean (the statistic used in most of the financial ratio analysis published to date) is not a good way to measure financial relationships for the small business population. The reasons for this are primarily, the large variance and skewness in the data at the smaller end of the size spectrum and the sensitivity of such estimators to "outliers". The method finally adopted was that of isolating the principal components of the distribution and using these as the independent variables in the regression equations. Using this method of estimation, it was found that while there are significant inter-sectoral differences in key financial relationships, there was little tendency for these relationships to vary with firm size when the first principal component was used as the measure of size. A more complete discussion of the method of estimation and the results is contained in "A Profile of Small Business Canada". What follows is an outline of the principal findings.

(a) Asset to Sales Relationship

The sales/asset relationship is of interest as a proxy measure for the presence of economies of scale or indivisibilities within an industry structure. In the majority of sectors, the hypothesis that the slope of the function is not statistically different from one could not be rejected. For most sectors then, the returns to scale within the size range of the independent, incorporated, small business population appear to be constant.

Only a few sectors (e.g. wholesalers of petroleum products, food stores, gasoline service stations) exhibited a slope greater than one, indicating the presence of economies of scale or indivisibilities. There appeared to be no cases where the slope was less than one -- diseconomies of scale.

(b) Debt to Assets Relationship

Over the size range of the independent, incorporated small business population there was little tendency for smaller firms to be more or less encumbered with debt than larger firms. The debt to asset ratio does, however, vary considerably between sectors. The most highly encumbered sectors (electrical products, office and store equipment manufacturers, computer manufacturers) exhibit an average ratio of 80 cents of debt for each dollar of assets. Since equity represents 20 cents of each dollar of assets, the debt to equity ratio is four-to-one.

The lowest average ratio was that for drugstores. Each dollar of assets carried 50 cents in debt -- a debt/equity ratio of 1/1. The average over all sectors was .63 -- a debt/equity ratio of 1.7/1.

(c) Profit to Sales Relationship

Overall, it was found that there is no strong tendency for pre-tax profit to vary with firm size. The variance at the lower end of the size spectrum is relatively large and highly skewed and this sharply influences the estimate of the mean. Using the mean under these conditions (a more detailed discussion can be found in the "Profile" paper) would suggest that smaller firms are relatively more profitable. What it is in fact showing is that some firms are doing very well indeed, and this raises the average for the group. Using the median as a measure of profitability suggests that, in the case of the retail food stores sector, only half of the population has a profit in excess of two percent of sales while the other half has less. In other words, the chances of earning more than two percent profit on sales are no greater for smaller firms than they are for larger.

Of interest, too, is the fact that the interquartile spread narrows with firm size. The spread can be interpreted as a measure of risk. At the smaller end, the range of possible outcomes is much larger, increasing the risk level attached to making a "normal" profit.

(d) Profit to Assets Relationship

Profit, before interest and income taxes, as a percentage of assets employed showed little tendency to vary with firm size when the latter is measured in terms of the first principal component of sales and assets. The intercept, which measures the return per dollar of asset employed, varies considerably by sector. It ranges from a low of a slight loss for the taxicab sector to a high of 37 cents per dollar of assets employed in the services to business management. The latter result reflects primarily the low capital/labour ratio of the sector. The average return for all sectors was 15 cents per dollar of assets employed.

The intercept (pre-tax profit as a percentage of sales) varies considerably between sectors. It ranges from a high of 24 percent for the services to business management sector to a low 1/10 of one percent for the plywood and milling sector. The average of all sectors is seven percent. Some sectors (clothing, miscellaneous furniture manufacturers) had a negative intercept, indicating a loss of each dollar of sales for a large number of the firms involved.

e) Differences Between Sectors

While the analysis of financial relationships did not produce many instances where the ratios varied significantly by firm size, there were substantial differences in these ratios by industry sector. Such differences are to be expected since each industry sector has its own characteristic production function. Therefore, it is not meaningful to speak of typical financial ratios for small businesses as a group. Instead, typical or "benchmark" ratios were developed for each industry sector separately.

Loan Size and Interest Burden

Of some interest is the average loan size, interest burden and debt structure of "normal" or "core" firms. These are firms whose sales-asset relationships suggests that they are not start-up, turn-around or exiting firms. Given the data source, the classification of normal firms is somewhat crude in nature. Similarly, loan size represents the average short and long term indebtedness of a firm, and not necessarily the average size of each loan. Since new loans are generally written to cover previous indebtedness as well as any increase, average indebtedness is a reasonable proxy for loan size.

(a) Loan Size

Table 10 presents the average operating and term indebtedness by firm size class. For the smallest size class at least 52% of the firms do not have a bank loan of any type, although they may have a loan from another institution or investor. Of those that do have a loan, most take the form of an operating loan.

As firm size increases the percent of firms without a bank loan drops to about 10% on average. About 70% of the larger firms have an operating loan and 20% have a term loan. Since a firm can have both types of loans the number of firms in the larger size classes without a loan will be understated.

Generally the average term indebtedness is less than the average operating loan, except for the two largest classes. A firm must have (in 1977 dollars) more than a million dollars in sales and assets before bank indebtedness exceeds $100,000. For firms with $500,000 in sales the average term loan is just over $20,000.

TABLE 10

Average Loan Size
Approximate Core Firms
1977 Statistics Canada
Corporate Financial Statistics Sample File

Sales Class ('000)	and Asset Class ('000)	Minimum Percent Of Firms Without A Loan	Operating Loan Percent* Of Firms	Operating Loan Size ('000)	Term Loan Percent* Of Firms	Term Loan Size ('000)
1-100	250	52.4	40.1	14.0	7.4	17.5
100-150	250	31.0	58.2	20.7	10.7	22.9
250-500	250	28.0	61.6	28.1	10.3	21.8
	250-1000	19.4	65.1	72.3	15.3	78.0
500-1000	250-1000	21.4	65.1	91.3	13.5	71.8
1000-5000	250-1000	23.5	65.8	124.6	10.7	68.2
	1000-5000	12.8	70.8	339.0	16.5	258.2
5000-10000	1000-5000	14.6	72.0	480.4	13.4	403.0
	5000-10000	11.2	67.4	1168.2	21.4	947.7
10000-25000	5000-10000	9.2	72.2	1248.2	18.2	878.6
	10000 Plus	8.6	68.2	2518.9	23.2	3926.4
25000 Plus	10000 Plus	15.5	63.8	6442.2	20.7	7439.5

* Cumulative

(b) Interest Burden

With the advent of high and volatile interest rates, some idea of the impact of this phenomenon on the firm's costs can be formed by comparing interest expense to total expenses. In a period of rising rates, those firms which have borrowed at a fixed rate of interest will see interest expense as a percent of total expense fall, whereas firms that borrowed on a floating rate basis (for whatever reason) may experience a relative increase in interest burden.

As Table 11 indicates, some 55%-60% of normal firms with sales of less than $100,000 paid no interest at all. Even a third of firms with sales less than $250,000 paid no mortgage, bond or loan interest of any type. In fact it is possible that 20% of the largest firms in the sample file have no interest bearing debt. Of those firms which do have interest expense, those with annual sales of less than $100,000 have the highest average burden. This could be due, in part, to the fact that firms in this size class also have the least amount of equity capital and the highest amount of shareholder loans in relation to total debt. If shareholder loans are taking the place of share capital, then interest on these loans is more in the order of a dividend.

For the remaining firms, interest burden ranges from 1.4% to 5% of total expense. The average is approximately 3%. Updating these estimates to reflect the 1981 situation requires new estimates for which data are not available. Simple extrapolation is difficult to use because: firms reduce debt in response to high rates; the increase in interest rates must be compared to the increase in other cost elements; some of the debt is carried at fixed rates; and increased costs are generally reflected in increased selling prices. Taking the extreme case where selling prices could not be increased, all the firm's debt was on a floating rate basis and other costs increased at the rate of inflation, an increase of 250% in interest rates (the chartered bank prime rate averaged 8.25% in 1977) would cause the average interest burden to increase to approximately 5%.

TABLE 11

Adjusted Interest Burden
For Those Firms Paying Interest
Approximate Core Firms: Corporation Sample File, 1977

Sales Class ('000)	and Asset Class ('000)	Overall Interest Burden %	Minimum Not Paying Interest %	Adjusted Interest Burden %	Maximum Not Paying Interest %	Adjusted Interest Burden %
1-100	250	3.2	55.0	7.1	60.0	8.0
100-250	250	1.8	29.8	2.5	37.9	2.8
250-500	250	1.3	18.7	1.6	29.6	1.8
	250-1000	3.6	.8	3.6	27.7	5.0
500-1000	250-1000	1.8	4.6	1.9	23.8	2.4
1000-5000	250-1000	1.0	5.5	1.1	22.4	1.3
	1000-5000	1.9	0.0	1.9	21.7	2.4
5000-10000	1000-5000	1.1	0.0	1.1	20.1	1.4
	5000-10000	2.3	0.0	2.3	24.8	3.1
10000-25000	5000-10000	1.1	0.0	1.1	25.5	1.5
	10000 plus	3.5	0.0	3.5	26.4	4.8
25000-50000	10000 plus	2.2	0.0	2.2	24.3	2.9
50000-100000	10000 plus	2.4	0.0	2.4	22.3	3.1
100000 Plus	10000 plus	3.7	0.0	3.7	20.3	4.7

THE FINANCING NEEDS OF SMALL BUSINESS: VIEWS FROM THE DEMAND SIDE

A Survey of Canadian-owned, Independent Firms: the FACSYM Study

In an effort to get first-hand evidence regarding the financing needs of small business, three surveys were commissioned. The major survey was conducted by FACSYM Research Limited a group of researchers headed by Douglas J. Tigert, Dean of the Faculty of Management Studies of the University of Toronto. The survey was directed by Professor Jamie Poapst.

It consisted of 300 direct interviews using a structured questionnaire on a sample of 3000 firms, stratified by 10 geographic centres but selected randomly within each centre. The survey itself was conducted during March and April, 1981 and a follow-up telephone survey of 120 firms was carried out in September, 1981. The survey focussed on the "independent" firms (annual sales in excess of $100,000 but less than $30 million) because of their relative importance to total business activity. If serious financing issues came to light with respect to the smaller firms in this sample, then an additional survey which focussed on just the smallest firms might have been warranted. The nature of the sample is such that it under represents firms in start-up situations and those in rural areas. The firms sampled were predominantly closely held Canadian owned enterprises. A full 98% claimed that none of their shares with voting privileges were held by the public.

A more detailed account of the survey methodology and results is contained in the study entitled "Small Business Financing and Non-Bank Financial Institutions". What is reported below are key results which were derived from tabulations made by the review team.

Search for Capital

For short term debt, chartered banks proved the most popular source of funds. Virtually all firms ranked banks as their first choice of supply, while shareholders were a distant second. The remaining financial institutions (Trust Companies, Financial Corporations and others) were cited by only some 10% of firms.

For long term capital, banks were again the most popular choice, although 23% of the firms would not apparently consider approaching a bank for long term debt. However, of those that would approach a chartered bank, most rated it as their first choice. Some 29% of the respondents rated the Federal Business Development Bank as an important source to approach for long term funds. Just as many indentified shareholders. Generally though, shareholders were more likely to be approached first.

Recent Financing Experience

Of those firms that had raised funds externally in the past three years (not all did) 85% did so at a chartered bank. No other institution made up a significant proportion of the remaining responses.

Two-thirds of the loans were short term in nature, while another 28% were long term. The remaining 6% were for leases, equity or "other". The banks accounted for 97% of short term financing and 66% of the long term loans.

Table 12 indicates how the respondents believed their financing needs had been served by the institutions they had dealt with over the past three years. In general the firms ranked the institutions as very good or adequate. Few felt they had been poorly served.

Table 12

Rating of Experience with Financial Institutions

Institution	very poor	adequate	very good
Bank	8.8%	38.1%	53.2%
Trust Company	6.7	26.7	66.7
Financial Corporation	8.3	12.5	79.2
FBDB	11.8	23.5	64.7

When asked to rate their recent financing experience, 74% of firms said they always obtained as much as they applied for.

Table 13

Ability to Obtain Requested Funds

Sales Size	Always Obtained Requested Funds	Usually Obtained Requested Funds	Usually Did Not Obtain Requested Funds
$100,000 - $500,000	71.6%	19.4%	9.0%
$500,000 - $ 1 million	67.3	19.2	13.5
$1 million and above	78.5	12.3	9.2
All firms	74.4	15.7	10.0

Another concern is the availability of funds on terms that the firm thinks are acceptable. Table 14 presents the percentage of firms in each size class which turned down an offer of a short or long term loan, a lease or equity financing. As the table demonstrates the larger the firm the more likely it has turned down offers in the past three years.

This phenomenon may reflect a number of factors. Larger firms may have more alternative sources of funds either through increased searching or through unsolicited requests. Smaller firms, on the other hand, may be more a captive of one institution or the size of the transaction limits the time which can be profitably spent on search.

Table 14

The Percentage of Firms Turning Down an Offer of Various Types of Financing

Sales Size	Short Term	Long Term	Lease	Equity
$100,000 - $500,000	5.3	8.5	6.0	--
$500,000 - $1 million	18.4	18.8	17.8	11.1
$1 million and above	28.3	24.0	16.8	12.6

The reasons for rejecting offers of short or long term financing are presented in Table 15. The primary reason for rejection was too high a rate of interest; none of the other reasons was nearly as important.

Table 15

Factors in Rejecting Short and Long Term Financing: All Firms

	Short Term		Long Term	
Factor	Rank	% checking extremely important	Rank	% checking extremely important
Interest rate too high	1	74.2	1	82.9
Personal guarantee	2	44.9	2	44.9
Too much collateral required	3	44.7	4	43.9
Not enough funds	4	43.0	3	45.4
Convenants too restrictive	5	41.8	5	38.1
Repayment too rapid	6	30.5	6	32.9

Very few of the firms prepared a budget projection of financing needs. Of those that did, the median projection was for just over one year. Firms with or without a budget generally felt quite certain about raising the funds they required in the near future.

One commonly heard complaint is that a large number of firms have their request for financing turned down by financial institutions. What is important, however, is whether or not a firm finds alternative financing. As Table 16 indicates, the difference between the initial turn-down rate and the ultimate turn-down rate is significant. Moreover, the primary reason for a refusal given by the institution was the poor financial position of the company (78.9%). Fully one-third of those refused also concurred with the institution's reason.

Table 16

Request for Financing Refused by Size of Firm

Sales Size	Percent Not Refused	Percent Refused	Percent Ultimately Unable to find Financing
$100,000-$500,000	89.5	10.5	4.0
$500,000-1 million	77.8	22.2	9.2
$1 million and above	90.1	9.9	5.3

Business Objectives and Concerns

A business' objectives can reflect, to a large extent, the nature and organization of the business. Maintaining independence and control proved to be the primary objective of smaller businesses. Of the problems facing business, financing concerns proved to be far down the list. There was virtually no difference in ranking across the three size strata. The smallest firms, however, tended to rank the importance of financing slightly lower. Table 17 reports the results for all firms.

Table 17

Ranking of Concerns

Rank	Concerns
1	Marketing Effectiveness
2	Cost Controls
3	Availability of Skilled Help
4	Inflation
5	Production
6	Financing
7	Personal Taxes
8	Corporate Taxes
9	Government Red Tape
10	Unreliability of Essential Services
11	Cost of Professional Services
12	Labour Relations

Awareness of Government Programs

The federal government provides many forms of assistance to small business. Each respondent was asked to list various programs they were aware of or have made use of at any time.

The FBDB had the highest level of awareness followed by Manpower and DREE. Indeed the FBDB outranked other programs by a margin of two to one. More firms had heard of the Small Business Development Bond, than the SBLA program, despite the newness of the Bond program.

A Survey of Chartered Bank and FBDB Customers: The Wynant Study

As part of the study commissioned jointly by the Canadian Bankers' Association and the Department of Industry, Trade and Commerce, a team of researchers headed by Professor Larry Wynant from the University of Western Ontario School of Business attempted to ascertain the views of those whose loan application files had been selected for study. Financial management in these businesses and the business managers' experiences in dealing with the chartered banks and the FBDB were investigated through a mail questionnaire, interviews with a sample of small businesses, and discussions with accounting firms which provide financial consulting to small and other businesses. A full description of the survey methodology and results is contained in the study entitled "A Study of Chartered Bank Financing of Small Business in Canada" which has been made available under separate cover.

The survey respondents tended to be somewhat larger than non-respondents in terms of sales, assets, number of employees and size of bank loans. The respondents also were established for a longer period of time and a relatively high proportion were or had been FBDB clients. In addition, the sample contained a predetermined number of files where loan applications had been rejected. As a result it is difficult to generalize from the survey and interview results to the population of small businesses. The survey does, however, offer some interesting observations regarding the bank/business relationship.

The Wynant survey indicates a higher initial turn-down rate than the FACSYM survey. This could be due to the fact that the Wynant sample contains a disproportionate number of FBDB clients, relative to their population weight. As a result (and perhaps indicative of a response bias) a relatively high percentage of the respondents were FBDB clients. Because of its role as a supplemental lender, it is expected that FBDB clients would have had their initial request turned down by a bank. The sample also contained a predetermined number of rejections which could influence the results.

Most of the respondents whose loan applications had been turned down reported that the reason given was a lack of security or uncertain profit prospects. Very few reported that they were turned down because of questionable management ability. The loan application files, however, list insufficient management skills as the major reason for a loan decline. It would appear that the banks are perhaps reluctant to tell the applicant that weak management was a factor.

It is also interesting to note that of those respondents whose initial approach was turned down, the majority (77%) found accommodation elsewhere: 30% of them at another bank, 31% at FBDB and the remainder through private sources or other financial institutions. In all, some 8% of the respondents were ultimately unable to find the desired financing. This is consistent with the results of the FACSYM survey.

Perhaps the primary area of dissatisfaction claimed by the respondents was the amount of collateral required by the banks. Collateral was the principal reason suggested for both loan turndowns and the bank's reason to offer less financing than requested. The specific reasons for dissatisfaction centered on the amount of collateral required and the banks' requests for personal guarantees or the pledge of personal assets.

Many respondents could not understand why such low ratios were offered for accounts receivable and inventory by the banks, as these were the prime collateral available for their loans. Most of the small businesses interviewed argued that the banks tied up all business and personal collateral. This collateral would then not be available as security to offer other sources of financing. However, the questionnaire and other interviews suggest that small businesses usually did not attempt to raise additional financing from other lenders and did not investigate whether or not adequate collateral was available for these lenders with secondary charges on the business and personal assets.

The claim of excessive collateral made by the small businesses that were interviewed was usually based on a comparison of the investment made by the company in its assets relative to the loan requested. The small business typically did not have a recent appraisal of the value of the assets or their likely value if they had to be liquidated to repay bank loans.

The majority of the respondents stated that the interest rate charged was not greater than they expected. Those who did feel that interest rates were excessive did not generally hold the chartered banks responsible.

While those interviewed did not generally disagree with the overall interest rate charged by the banks, they often expressed dissatisfaction with hidden costs of obtaining loans such as the audit and legal fees. The costs of gathering financial information required by the bank, and the negotiation and cancellation fees charged by some of the banks to prevent them from shopping for a loan at other chartered banks, were a source of irritation for many of the small businessperson's interviewed. They believed that these hidden costs sometimes outweighed the interest costs on the overall loan.

Further evidence of dissatisfaction lies in the frequency of instances where the respondent had switched banks or shopped for loan terms at another bank. A high incidence of shopping or switching banks is, on the one hand, a positive signal of market competition. On the other hand, it could indicate that small businesses have been dissatisfied with their banking relationship. The reason for switching stems from a loan turndown or general discontent.

Aside from loan terms, other aspects of the bank/small business relationship may cause general dissatisfaction. Several aspects were explored through the survey questions and interviews. The major areas of discontent include the banker's knowledge and understanding of the small business' operations and the loan negotiation and approval process.

The majority of the respondents felt that their banker knew and understood their business. The survey results suggest that two factors may partially account for the dissatisfaction expressed by the remainder: the level of bank personnel turnover and the infrequency of visits by the banker to the customer's premises.

An Examination of the Need for Venture Capital: the Thorne Riddell Study

In an attempt to gain an understanding of the views and attitudes of people who own and operate a small business as to the need for venture capital, the firm of Thorne Riddell was commissioned to conduct a series of focus group meetings in cities across Canada.

Firms were selected on the following basis:

- be owner-managed;
- be in business at least 12 months;
- have at least one employee in terms of a direct labour expense;
- were doing at least $500,000 per year in sales volume. Firms with annual sales in excess of $500,000 account for 50% of the total sales of Canadian-owned, independent group of firms.

Focus group discussions were conducted in Toronto, Montreal, Vancouver, Calgary and Halifax. Those businesses represented had been in existence over a period of time, from just over one year to more than forty years, with the majority in business more than five years. A cross-section of small business operations was represented in the sample, although emphasis was placed on the manufacturing sector. Also represented were some wholesalers, retailers and service industries. A total of 112 respondents participated in the meetings.

This research indicated that there was a distinct lack of understanding on the part of people who operate small businesses as to what is meant by venture capital. There was also a lack of awareness as to the existing sources of such funds and a sharp apprehension about raising equity capital from venture capital suppliers.

The strong desire to maintain control of their enterprises and hence, preserve their prized independence, led most participants to regard the surrender of any portion of the equity in their firm as something to be avoided. Some of the respondents indicated that they might surrender a portion of their equity on a "silent partner" basis - i.e. if the investor did not interfere with the operation of the firm but could supply marketing or other expertise if requested.

Given the nature of the sample and method employed, it is not possible to generalize the results to the population of small businessses. At most, this research can shed some light on the attitudes of the owners of larger, more established "small" businesses.

While it is not possible to generalize the results of qualitative research, the findings suggest that the need for venture capital will be very difficult to establish and will not be independent of the "product" being offered. If, for example, what is being offered amounts to zero priced capital that never has to be repaid then the demand will likely be quite large. If, on the other hand, the product being offered involves participation in the operation of the company then resistance can be expected.

The results of the Thorne Riddell study tend to be supported by the FACSYM study. Most of the FACSYM respondents did not foresee any particular problem in obtaining the required financing - including equity capital. Of those firms which prepared financial budgets, 67% did not foresee any need for equity capital. For those who foresaw some need, their preferred source of supply was existing shareholders. The second choice was FBDB. In all, there was a singular lack of evidence to support a contention that there is a pressing need for additional equity capital. It should be noted, however, that the FACSYM survey does not adequately reflect start-up situations or the equity capital needs of firms whose annual sales are less than $100,000.

An Interpretation of the Surveys

Each of the surveys has its limitations: the FACSYM survey is most representative of established, incorporated firms with annual sales in excess of $100,000 and appears (possibly as a consequence) to somewhat under-represent very new firms. The Wynant study similarly under-represents the smallest firms. In addition, the inclusion of FBDB customers and a predetermined number of loan rejections in the Wynant sample raises problems of bias and representativeness.

The purpose of tre surveys was, however, to gain a first hand understanding of the views of owners and operators of small businesses. Because these views are of interest to the government, bankers and venture capitalists in improving the design and delivery of their products, the major conclusions that can be drawn concerning small business perceptions of the capital market are listed below.

1) Interest costs and security requirements ranked as the key factors in assessing the adequacy of available financing.
2) Small business persons would like their bankers to show more interest in their business, and learn more about them. The turnover of bank branch managers is a frequently mentioned irritant.
3) Bankers are seen as excessively cautious, especially with regard to the valuation of collateral.
4) Small business persons are reasonably satisfied with the way the financial system deals with them, with the exceptions noted above.
5) Financing does not rank high on the list of concerns of small business. Day to day operating problems far outweigh financing problems.

The FACSYM survey attempted to obtain some information on the process of search for financing. What it found was that the large majority of businesses, when they need financing, approach their bank and often nobody else. Most firms (91%) believed that their financing needs had been looked after adequately or very well by the banks. The general level of awareness of the variety of financing sources was found by all three studies to be quite low.

The most direct information on the presence or absence of "gaps" comes from questions relating to actual financing experience. The FACSYM survey reports that 90% of the respondents usually obtained all the funds they sought in their recent financing episodes, a figure that varied little with firm size. About 12% of the sample had been turned down in a loan application in the past three years. Half of these firms eventually found financing elsewhere, leaving a core of about 6% that did not receive the desired loan. The survey does not indicate how much effort those refused put into finding an alternative source, or what rates they would have been prepared to pay.

Probably the most important result of the surveys is what they did not find. In the population sampled, the surveys did not uncover evidence of a serious financing problem even though one of the surveys was conducted when interest rates were reaching historic highs. If there was a serious problem, some evidence should have been brought to light as a result of the surveys and focus meetings. If a case is to be made for the existence of "gaps" then, on present evidence, the gaps must be found largely in the smaller end of the size spectrum (firms with annual sales of less than $100,000), firms in a start-up situation or firms located in rural areas.

VIEWS FROM THE SUPPLY SIDE

Financial Market Overview

An often voiced concern regarding small business financing is that the increased institutionalization of savings in the Canadian economy could prejudice the flow of funds to smaller businesses -- in particular those without access to capital markets. In a paper entitled "The Capital Market and Small Business" D.G. McFetridge, Professor of Economics, Carleton University, examined changes in net lending and borrowing and changes in market shares of the financial intermediaries.

Net Lending and Borrowing

An examination of the pattern of new lending and borrowing in the Canadian economy between 1970 and 1979 revealed that, beginning in 1975, the federal government moved from a position of approximate balance to one of a large net borrower. The net borrowings of government non financial enterprises also increased markedly at the same time.

This increase in net borrowing was accommodated largely by an increase in lending to Canada by foreigners and a decrease in net borrowing by private non-financial corporations. The decline in net borrowing by private non-financial corporations probably caused and was at least coincident with a decline in non-financial asset acquisition (investment) in this sector.

Household Financial Asset Acquisition

The largest net lender in the Canadian capital market is the household and unincorporated business sector. During the period 1970-1979, this sector continued to allocate its financial asset acquisitions between deposits on one hand and life insurance and pensions on the other in a manner which varied from year to year, but which showed no trend.

The allocation of new assets between indirect (intermediary) lending and direct lending also varied markedly from year to year but showed no trend. Direct lending to business in the form of acquisitions of common stock, corporate bonds and commercial paper was negative for the second half of the decade and, in the case of common stock, for nine of the ten years in the decade. During the last half of the decade household direct lending took the form of government bill and bond purchases and intrasectoral mortgage lending.

The decline in direct lending to business is at least in part a consequence of the large net borrowing of the federal government which began in 1975. It is of little direct relevance to small business in that the latter has not been a major participant in commercial paper, bond and equity markets. To the extent that discouraged direct borrowers turn to intermediaries, however, small business would also be obliged to adjust to the decline in direct lending to the private sector by households.

Intermediary Financial Asset Acquisition and Market Shares

Deposit taking institutions (banks and near banks) accounted for an average of 70 percent of the growth in the value of financial assets held by all private financial institutions during the period 1970-80. This share does not appear to be either increasing or decreasing. Among deposit-taking insitutions, chartered banks accounted for an average of 68 percent of the increase in financial asset holdings over the period 1970-80. Again, this fraction exhibits no trend. Credit Unions accounted for between 7 and 17 percent of the growth in financial asset holdings of deposit-taking intermediaries while trust companies accounted for an average of 13 percent of this growth. There was no discernible trend in either case.

Insurance companies and pension funds together accounted for an average of 19 percent of the growth in the financial asset holdings of all private intermediaries. While it varied between 16 and 23 percent, this proportion displayed no trend.

After 1974, (Life) Insurance Companies accounted for a steadily declining and Trusteed Pension Funds for a steadily increasing share of the financial asset acquisitions of this group. Between 1974 and 1980, the Pension Fund share of group asset growth rose from 52 to 68 percent while its share of aggregate intermediary asset growth rose from 8.8 to 12.2 percent.

Other Private Financial Institutions accounted for an average of 11 percent of the growth in financial assets held by private intermediaries. Of the subclasses of insitutions which are identified in the Financial Flow Accounts, one, Mutual Funds, was a net seller of financial assets over the period 1970-80. Two others, Investment Dealers and Sales Finance and Consumer Loan Companies were net sellers of financial assets in one or more years during the decade.

Focusing on the last half of the decade, Fire and Casualty Insurance Companies, Mortgage Investment Trust Corporations and Sales Finance and Consumer Loan Companies have all been net buyers of financial assets every year since 1974. Taken either individually or as a group, however, these classes of intermediaries have accounted for a steadily declining fraction of the private intermediary financial asset acquisitions.

The remainder of the "Other Private Financial Institutions" class consists of intermediaries not identified elsewhere. This subclass includes holding companies (closed end funds), finance leasing companies, venture capital companies and business finance companies (Canadian affiliates of foreign banks). Taken together, the groups of intermediaries in this residual category have accounted for a steadily increasing share of the growth in intermediary financial asset holdings moving from one percent in 1970 to eight percent in 1980. Much of this increase is said to be due to the expansion of the Canadian affiliates of foreign owned banks during the last half of the decade.

When the financial asset acquisitions of government and private intermediaries are combined, one finds that intermediaries owned by the federal and provincial governments accounted for an average of 8.3 percent of all intermediary financial asset acquisitions between 1970 and 1980. This share reached a maximum of twelve percent in 1970 and has declined steadily since 1975.

The implication of this analysis is that, with the possible exception of sales finance companies, the private sector intermediaries which lend to small business have maintained their share of intermediating activity. There is nothing in this share analysis to indicate that the intermediaries which lend to small business cannot place their liabilities and that small business is "starved for funds" as a consequence.

Trends in the Market for Term Loans

Another factor affecting the availability of small business financing is the changes that have taken place in capital markets over the last 10 to 15 years. Many of these developments have been brought about by changes in regulations (the 1967 and 1980 amendments to the Bank Act) allowing for greater competition for certain types of business while others have come about as a result of changes in institutional practices. Regardless of the reason, it is clear that significant changes have taken place. A particularly important development is the one that has taken place in the term lending market for small business loans.

Chartered Banks

Prior to the 1967 revision of the Bank Act the banks were not permitted to charge interest rates in excess of 6% per annum. When interest rates were generally low this provision did not have a significant impact on bank operations. But as interest rates increased in the 1950s and 1960s the interest rate ceiling began to have an effect. The keystone of the structure of interest rates on bank loans is the prime rate charged on loans made to the largest and "best" customers. As the size of loan diminishes and the risk and cost of servicing the loan increases, the rate charged also increases. If the prime rate for some reason increases, so do the rates charged on most other loans made by the banks. As the prime rate approached the old ceiling of 6% the banks were forced to deny credit to worthy customers because the permitted maximum of 6% did not adequately cover the cost of servicing those loans that normally would have been made at above prime interest rates. By mid-1962 the chartered banks' prime rate was at the 6% ceiling, and from then until the removal of the ceiling in 1967 the prime rate remained at, or very little below, the ceiling. Clearly, this left little room if any to operate at a profit.

Also affecting the extent to which the banks were prepared to make term loans was the security they were allowed to take. Initially, the Bank Act was written in such a manner as to encourage the banks to make short-term, "self-liquidating" loans to facilitate production and distribution. Section 86 of the Act permitted the banks to make loans secured by warehouse receipts or bills of lading while Section 88 permitted loans on the direct security of specified goods still in the hands of farmers, manufacturers and wholesalers. By contrast, other sections of the Act specifically prohibited the chartered banks from making loans secured by long-lived capital equipment, buildings or land.

However, beginning with the 1937 amendment to the Bank Act this blanket prohibition was progressively eased. The final step was taken in 1967 when the prohibition against mortgage lending was removed. Following the removal of these restrictions the chartered banks progressively expanded their term lending activity. At first, they concentrated on the larger size loans. As experience was gained, they made more and more smaller loans. Today, the banks account for 47% of all term loans of less than $5 million in size, and the smaller size loans (loans of less than $200,000) are the fastest growing segment of this portfolio.

Total chartered bank lending to business has grown at an average annual rate of 16.5% in nominal terms during the period 1974-80. During the same period average term loans outstanding grew at an annual average rate of 19.3% (10.2% in real terms). As a result, an increasing fraction of business loans outstanding is in the form of term loans.

While data on chartered bank term lending for authorizations under $200,000 are not available, loans of this class can be estimated using data on total business loans outstanding with authorizations under $200,000 and the fraction of total business loans with authorizations between $200,000 and $1 million which are term. The analysis of loan size (Table 10) indicates that the relationship between operating and term loans for the group of firms which would have loans of less than $200,000 in size is roughly comparable to that for firms which would have loans in $200,000 to $1 million range. Since the banks also supply most of the term loans as well as the operating credit for firms in this size range, the relationship of term loans to total business loans for the $200,000 to $1 million category should provide a reasonable basis for estimating the term loan component in the under $200,000 category.

Actual and estimated chartered bank term loans outstanding for the years 1974-1980 are reported in Table 18. Average outstanding loans in the two smallest size classes grew in nominal terms, at the fastest rates averaging 23.3% per annum in the under $200,000 size class ;and 23.6% per annum in the $200,000-$1 million size class. Six year average growth rates in the $1-$5 million and over $5 million size classes were 14.7% and 18.8% respectively.

Table 18

Chartered Bank Term Loans Outstanding
($Millions)

Year	Less than $200,000*	$200,000- $1 million	$1 million- $5 million	Over $5 million	All Term
1974	741	789	1160	2565	5363
1975	928	942	1345	3070	6424
1976	1146	1266	1627	3736	7961
1977	1598	1685	1855	4278	9640
1978	2065	2259	2074	4447	11123
1979	2543	2857	2415	5815	14013
1980	2884	3244	2798	7947	17427

*estimated outstanding loans are annual averages including SBLA loans.

Proper analysis of the change in the size distribution of business term lending over this period requires that loans be assigned to size classes on the basis of their constant (1974) dollar authorization rather than their current dollar authorization. Examination of the resulting adjusted real growth rates in business term lending reveals that, while all size classes of business term lending grew faster than the Canadian dollar assets of the chartered banks, the difference is greatest in the cases of the two smallest loan size classes. Business term loans outstanding under authorizations of less than 200 thousand 1974 dollars grew at an annual rate of 15.9%, nearly three times the growth rate of the banks' Canadian dollar assets. Business term loans outstanding under authorizations between 200 thousand and 1 million 1974 dollars grew at an annual rate of 14.4% more than twice the growth rate of Canadian dollar assets as a whole.

Foreign Bank Affiliates

It is reported that there are some 98 affiliates of foreign banks in Canada which are conducting either an agency or lending business. Of these, 47 have been granted bank status under the 1980 revision to the Bank Act. Undoubtedly, others will also apply, so that by the end of 1982, there could be as many as 60 foreign banks engaging in intermediation in Canada. The entry and recent rapid growth of market shares of these financial institutions has been a major force for change in the term loan market in Canada.

Foreign bank affiliates deal almost exclusively with business clients. Their clientele tends to be drawn from Canadian medium-sized businesses (mainly the larger firms in this category), Canadian subsidiaries of foreign firms and to a lesser extent the large scale Canadian firms and their subsidiaries.

The business loans of foreign bank affiliates are equally divided between term and operating loans. Of the term loans, it is estimated that approximately 40% are authorized between $200,000 and $5 million. The average annual real growth rate in loans of this class outstanding was 31.5% between 1974 and 1980. This growth rate is considerably in excess of that recorded by most other financial intermediaries during the same period.

This growth rate is not, however, likely to be maintained. Once the assets of foreign banks reach 8% of the Canadian dollar asset holdings of chartered banks (including foreign currency business with Canadian residents booked in Canada) their growth rate is limited by the Bank Act to that of chartered banks. The 8% ceiling should be reached by mid 1983.

While the foreign banks have not been active in the smaller end of the term loan market (authorizations less than $200,000) this could change as a result of the 1980 Bank Act amendments. A number of foreign banks have indicated that they intend to specialize in the ethnic communities in which they are known. This could lead to financing of businesses in that community and hence benefit small businesses.

Market Shares

While the data on the term loan market is skimpy, the best available estimate (See "An Analysis of the Term Loan Market" by J.R. D'Cruz) indicates that the total value of term loans outstanding under authorizations less than $5 million averaged $19 billion during fiscal 1980. Chartered banks accounted for 47% of this market.

The shares of the market accounted for by other lending institutions in order of their relative importance are: sales finance companies, 19.6%; FBDB, 10.6%; provincial government agencies, 7.9%; credit unions, 3.5%; foreign bank affiliates, 3.3%; RoyNat, 4.5%; trust companies 2.3% and financial corporations, 1.1%.

With a market share of close to 11 percent the FBDB is the largest single institution in this market. No single chartered bank has a larger portfolio of term loans under $5 million in authorization.

Taken together, the lending programs of both the federal and provincial governments accounted for 24% of the value of term loans under $5 million in authorization outstanding during fiscal 1980. Since the bulk of subsidized lending takes place under authorization below $1 million, these programs will account for a significantly higher share of the lending in this segment of the market.

The Lending Practices of Chartered Banks: the Wynant Study

Because of the dominant role of chartered banks in the financing of small business enterprises, the University of Western Ontario team conducted an extensive analysis of a sample of 1800 loan applications drawn from the files of banks in each of the regions across Canada. The sample was stratified by region and by banks within the regions. Files were then drawn randomly from the division files of the selected banks. Overall the sample is a reasonable representation of the size and industry distribution of the small business population. The major difficulty with the sample is that it does not capture loan applications which are rejected "at the desk" -- i.e. those that do not get to the application stage. To compensate, a predetermined number (20% of the sample) of rejections were added to the sample. In addition, the team interviewed bank personnel in the branches, divisions and head offices.

Six major aspects of the loan package provided to small versus large businesses were analyzed: the rate charged for bank loans, the availability of term loans, the amount of bank financing provided, the collateral support demanded by the banks, the conditions imposed on the borrower and the time required by the bank to reach a decision. Each of these loan characteristics was analyzed to determine: first, if there were differences in the treatment of small and large borrowers; second, if the observed differences could be explained as a reasonable business practice because of differences in the riskiness or cost of administering small versus large loans; and third, if the lending decision was affected by the characteristics of the branch where the borrower banked.

Major Findings

a) Reluctance to Make High Risk Loans.

The study of the lending practices of the chartered banks indicated some areas where a gap might exist with respect to the supply of funds to small business. The most notable area is that class of loans which the banks do not regard as "bankable" at a rate of prime plus 3% and hence discourage. Less than 1% of the loans in the sample were made at rates greater than prime plus 3%. In effect, the banks do not price for risk beyond prime plus 3%, thus creating a possible basis for profitable exchange between borrowers and lenders at rates of prime plus 3% and up.

By "bankable", loan officers mean that the prospects of the loan being repaid from earnings or collateral are virtually certain. Loans which do not fall into this category are discouraged, regardless of the rate of interest that could be charged. The reasons most frequently cited are that such loans would subject the bank and its depositors to unacceptable risk and the bank might be accused of "gouging" its customers.

The types of loan which fall into the unbankable category are: those with very long maturities (more than 10 years); fixed rate loans; inventory loans; start-up situations; cash flow loans; loans to industries in trouble (currently, construction and mobile home manufacturers); loans for equity or venture capital. Since requests for this type of accommodation are made most frequently by smaller size businesses, the reluctance of the banks to price for risk would affect them the most.

Interviews with loan officers and branch managers also indicated that as many as 25% of loan requests received are likely to be turned down as unacceptable. The reasons cited include: equity insufficient (69%); not enough collateral (57%); not convinced the business is viable (56%); doubts about management capability (34%). The majority of the rejections represent small business loans and start-up situations.

b) The Ability and Experience of Branch Managers

The frequency of declines also varied according to the ability and experience of the branch manager. The more senior managers and loan officers were more adept at structuring loan requests to make them acceptable to both the bank and the customer. These managers are typically found in the large and medium size branches.

The managers of smaller branches tended to be either young and inexperienced or an older person who has been passed over for promotion. These managers either lacked the knowledge or willingness to restructure loan requests to put them in a form which would be acceptable to the bank. Hence, the frequency of decline was higher for small branches than for medium and large size branches.

While smaller businesses are likely to be at somewhat of a disadvantage due to greater exposure to the smaller branches, the "gap" so created can best be remedied by better training and improved working relationships between smaller branches and divisional headquarters.

c) Discriminatory Pricing

Of interest too is a view widely held among bank managers and loan officers, that the prime rate is used primarily for national accounts. Less than 2% of the small businesses (loan size less than $200,000) in the Wynant sample had loans at the prime rate. Smaller businesses are typically charged prime plus 1% for an operating loan and prime plus 2% for a term loan.

The Wynant team devoted considerable effort in an attempt to find out if the differential rate was justified. After making allowances for differences in risk, it was found that smaller businesses still paid a premium of approximately 40 basis points. This premium was justified in terms of higher transaction costs per dollar of loan revenue. Since the banks do not cost loans by size, the evidence submitted was derived from a survey of branch managers. It should be noted however that the risk/price relationship is complex and hard to estimate.

d) Amount Granted

The Wynant study did not find any evidence to indicate that the banks tended to discriminate against smaller businesses in terms of the amount granted relative to the amount requested. This was supported by the FACSYM survey of small businesses which indicated that the majority of respondents usually obtained the amount of credit requested. The study also did not find evidence of discrimination as to the term of the loan or the conditions attached - i.e. restrictive covenants, information requirements.

e) Excessive Collateral Requirements

The study did find, however, that smaller companies more frequently provide personal guarantees and personal assets to support their guarantees. The additional collateral coverage by small firms amounted to approximately 50% of the authorized loan amount. Even after adjusting for risk it was found that collateral requirements placed on small firms is more stringent than that placed on larger firms.

The banks tend to justify the additional collateral requirements in terms of the additional risk involved. The additional risk flows from the dependence of the business on the health and capability of the owner/operator. The Wynant study tried to assess the reasonableness of the collateral requirements by examining 54 cases where default had occurred. It suggests that, given the recovery rates indicated by the sample, a collateral coverage of two to three times the amount of the loan is barely adequate. This evidence, however, must be viewed with caution. The sample is small, the data uneven and asset coverage admittedly weak.

f) Reluctance to Provide Fixed Rate Loans

Most of the term loans included in the sample were made on a floating rate basis. This practice has been followed for some time and it is likely to continue in the foreseeable future.

g) Study Limitations

The generality of these results must, however, be restricted. The Wynant study drew its sample of loan applications from divisional files. Only those loans which are in excess of the branch managers discretionary limit are sent to the division (regional) office for approval. The files for loan applications approved at the branch are retained at the branch. Since the discretionary limit of the branch managers varies considerably there is no systematic exclusion of a given size group. Similarly, there is no reason to believe that loans made at the branch differ from those approved at the division.

Major Conclusions as Reported in the Wynant Study

The major conclusion of this analysis is that small businesses are not treated by the banks in a substantially different fashion than are larger businesses. This is not surprising since interviews at all levels in the chartered banks suggested that bankers view small businesses as their primary market and attempt to accommodate their financing needs where the credit request is sufficiently strong.

Small businesses, in fact, receive more favourable treatment by the banks in terms of the amount of financing obtained relative to the amount requested, the covenants and information demands imposed on the business and the time taken by the banks to reach a loan decision. Two major differences that can possibly be considered as unfavourable to small business are higher interest rates paid on loans and the banks' insistence on personal guarantees and personal collateral from the principals in a small firm. The higher loan rates seem to be justified by the additional administrative costs (on a per dollar basis) in lending to small firms. The collateral difference seems to result from the characteristic that bankers would attribute as being most unique to small businesses, namely, the fundamental importance of the owner/operator in shaping the company's success.

Although it can be concluded that banks do not treat smaller businesses in a substantially different fashion than large firms, some general problems in the bank/business financing relationship were observed.

Certain factors in the business/banker interface may reduce the likelihood that sound business proposals will be financed. The lack of financial understanding by the small businessmen results in loan proposals that are often poorly prepared and presented to the bank. Several aspects of the lending process in the chartered banks also contribute to the likelihood that marginal or nonconventional loan requests will be declined. These are: inadequate skills on the part of junior branch managers to analyze the loan requests and negotiate with commercial customers; confusion amongst bankers with regard to bank policy for term lending and other special lending programs; and the importance that the bank lending process attaches to collateral protection in assessing credit risks.

Smaller businesses rely almost entirely on the banks for financing and advice and are generally unfamiliar with other funding options. However, many bankers, because of limited knowledge of financing options, are unable to play the role of financial advisor effectively in referring customers to alternative sources.

Lending Practices of Non-Bank Financial Institutions: The FACSYM Study

Since non-bank financial institutions supply an estimated 35% of the smaller term loans (less than $5 million in size), their role and performance was assessed in a study jointly funded by the federal government and non-bank institutions: trust companies, sales finance companies, RoyNat and the Canadian Co-operative Credit Society. The study involved an analysis of loan application files drawn from participating firms as well as interviews with lending officers.

Interviews with senior executives of non-bank financial institutions with responsibilities in the area of small business lending indicated an almost unanimous view that a small business with a well-conceived and realistic financing need is properly serviced and is, in fact, eagerly solicited by a variety of lenders. Such loan proposals are well secured by marketable collateral or well within the safety margins of debt carrying capacity. Financing which would leave lenders exposed to substantial default risks, however, is viewed as falling beyond that which should be provided through their term financing facilities. In such cases the business is in need of equity financing.

In addition, businesses such as retail stores, restaurants, recreational businesses and other service sector businesses were identified as sectors which have poor collateral to offer as security for term loans. As the assets of these businesses generally have little value in the event of liquidation, financing can be difficult unless more acceptable collateral is available as security.

Trust Companies

All of the trust companies reported mortgage lending as their main financing activity for small businesses. Mortgage lending was defined as a loan secured primarily by the value of real estate. Such loans generally carry a term of five years, at fixed interest and with an amortization period of up to twenty-five years.

Term lending to small businesses by trust companies has evolved from pure mortgage lending. Often real estate is still the principal collateral provided, but other collateral in the form of chattels or general liens may also be included. The prime distinction which is made in a term loan as compared to a pure mortgage loan is that the former is granted mainly on the credit capacity and cash flow of the business rather than on the collateral provided. The credit analysis required for the granting of term loans is substantially more complex than in mortgage lending and most trust companies are only beginning to acquire the personnel required for this activity. The reported term of such loans ranged from four to seven years with either fixed or floating interest rates and longer amortization periods.

The only other lending activity conducted directly within trust companies appears to be in interim financing for builders. This appears to be the only area of trust company activity in the short term lending markets and is generally linked to their mortgage lending activities.

Lacking extensive commitment to general small business lending, all interviewed organizations still have only very skeletal organizations for term lending activities. While the larger trust companies generally operate with a large number of branches, ranging from 52 to more than 200 in the interview sample, the number of term lending offices is generally restricted to a small head office group. Several organizations commented on their current attempts to develop a more extensive network of loan officers capable of dealing with term lending. Most are still only experimenting and are awaiting organizational commitment to the extensive development efforts which would be required. These are seen to be justified only if substantial volumes of business would be forthcoming.

Financial Corporations

The principal activity of financial corporations is equipment financing in the form of final sale equipment loans, equipment dealer inventory loans or equipment leasing. The equipment purchased is usually the major source of collateral for the loan. While lenders consider the credit position of the borrower, the collateral is viewed as providing the basic security. Higher ratio equipment loans (up to 80%) are now possible, compared to the historical past, because future resale values on equipment are providing greater protection to the lender. The term and amortization period of the loan is generally around four years and relates to the useful life of the equipment. Most of the loans appear to be centred on automobiles, trucks, construction equipment and aircraft with the remainder in moveable machinery ranging from printing presses or computers to mining equipment.

Associated with equipment loans are inventory loans to dealers of equipment. These are short-term loans of 60 to 90 day average duration secured by equipment inventory. Such dealer inventory loans are particularly important to so called "captive" credit corporations who, on occasion, provide subsidized financial support to the independent dealers of the parent company products. In effect, such financing is a form of supplier credit for major equipment inventories. As a result, independent financial corporations appear to be somewhat less active in this area.

The leasing activities of the financial corporations are similar in volume to equipment loans and in fact are viewed as offering essentially the same service only with alternative taxation implications. Under proper lease arrangements, the lessor gains the benefit of the capital cost allowances and tax credits provided. Borrowers with little taxable income or low rates of taxation could, in effect, transfer unusable tax-writeoffs to the lessor. Changes in the taxation provisions are currently restricting the write-offs to the amount of leasing income. The amount of assets committed to leasing to small businesses by financial corporations ranged from \$2.2 million to \$244 million, but appears not to be expanding.

RoyNat

The acknowledged largest non-bank term lender to small business is RoyNat. Its portfolio of assets is centered on term loans ranging from four to ten years in maturity with even longer amortization periods. Its annual volume is currently around \$350 million with an outstanding total of \$915 million. While land, plant and equipment are generally taken for security, the cash flow or earnings of the business are generally the prime consideration in granting loans. Quality of the management and collateral given are the other prime determinants of the credit decision. Active expansion of these term lending activities is being pursued. With an average loan size in the order of \$300,000, RoyNat operates in the larger end of the small business loan market.

Credit Unions

The Credit Union movement is a democratic, multilevel, decentralized organization. Individual credit unions are controlled by their members within the restrictions set by the Credit Unions Act of each province. The individual Credit Unions, in turn, govern a Credit Union Central in their respective provinces. Provincial centrals in each province except Quebec and Newfoundland along with several cooperative organizations have formed the Canadian Cooperative Credit Society (CCCS). The main purpose of CCCS and the provincial centrals is to provide liquidity by lending to, and taking deposits from, the member organizations.

The competitive position of Credit Unions varies by province and within provinces. The Credit Unions usually have a larger share of the market in smaller centres where banks are not as well represented. They also have a large share of the market in Western Canada where most centres have a community Credit Union with several branches. In Ontario, the Credit Unions with corporate affiliation may have a large share of the accounts of the employees of that company.

The Credit Unions in the sample surveyed were generally larger since smaller Credit Unions do not have the assets or expertise to handle commercial loans. All but two had assets over $30 million.

It is quite common for Credit Unions to specialize in certain types of commercial loans such as property mortgages, interim construction financing, or lines of credit, although some do lend to a broad spectrum of clients. The choice tends to be governed by local needs, opportunities, and competence. The rural Credit Unions are more likely to lend to a broad spectrum of borrowers because the loans are needed in a community with relatively few alternatives. Large urban Credit Unions tend to specialize in a particular type of loan because they do not have the skills to compete in all of the highly competitive markets in a large city. The selected specialty typically depends on the skill and interests of the management and the available opportunities in the community.

Required Spreads

Given the nature of the risks and costs in loans to small business, the senior executives involved in business lending indicated that a spread of 2 to 4 percentage points is required for profitable lending. Even this range was questioned by some as providing too narrow a range for smaller or riskier loans which in the past permitted spreads up to 8 percent. Given current market competitive conditions, most participants are experiencing a squeeze in obtainable spreads. An average of 2.5 percent was cited for larger term loans and possibly 3.0 percent in smaller equipment lease financing.

The effective costs of term loans to smaller businesses today appears to be in the range of prime plus one to two percent for larger loans and prime plus 3% for smaller loans. Most participants from NBFIs, however, expressed the opinion that the chartered banks, the foreign bank affiliates and the FBDB, all contribute to a generally insufficient spread due partly to their lower cost of funds and also to either a lack of market experience, to "penetration" or volume orientation or to public subsidization.

Matching of liability and asset maturities has been weak in most of the institutions interviewed and has resulted recently in either losses or a decline in profitability resulting from the sharply increased general level of interest rates. The ability to attract long term deposits has declined and shorter term investments or investments based on floating rates of interest are being sought.

Competitive Policy Considerations

In assessing their competitive position in small business lending markets, the senior executives invariably commented on the dominant position of the chartered banks. Their high leverage factors, in the order of 30:1, and access to less expensive deposit funds provide a cost of funds which cannot be matched by other participants. Their total size and the extensive branch networks which they operate provide banks with first access to most lending opportunities.

On the other hand, the lack of specific banker experience in term lending and the generalized training of local bank managers is cited as a competitive disadvantage for banks which creates opportunities for other term lenders.

Sources of Business Loans

In the course of interviews with senior mortgage and loan officers, respondents were asked where the financial institutions get their customers. The overall proportions compiled from a sample of 35 questionnaires are listed below. The results are weighted by the number of applications accepted.

	Source	Percentage
i)	direct solicitation	35
ii)	other	25
iii)	dealers	19
iv)	applicant	16
v)	developers	2
vi)	referrals from lenders	2
vii)	brokers	1

The "other" category frequently included repeat business from existing clients and sometimes advertising.

The striking feature of the distribution is that only about one-sixth of applications accepted were seen by the loan officers as arising directly from the initiative of the applicants. By far the largest source was direct solicitation by the supplier. Third-party sources (dealers, developers, brokers, referrals from lenders) accounted for nearly one-quarter of the total. Together these last two sources were about three-fifths of the total, and about four-fifths of the total excluding "other".

The distribution of the purposes for which loans were required, as estimated by loan officers, is listed below. Again, the proportions were weighted by the number of loans actually made.

	Purpose	Percentage
i)	equipment purchase	54
ii)	property acquisition	19
iii)	working capital	15
iv)	expansion	6
v)	refinancing	3
vi)	business acquisition	3
vii)	other	0

Equipment purchases, property acquisition, and working-capital requirements were the purpose for about seven-eighths of the loans made. Equipment purchases by themselves were more than one-half the total. This is consistent with the importance of equipment in the fixed assets of small businesses and its shorter life expectancy than real estate and working-capital (as distinct from its components).

Loan Terms and Conditions

The interest rate on loans is calculated in a variety of ways. Trust companies usually base it on a percentage above the current rate for their Guaranteed Investment Certificates. One firm uses a floating rate based on their average cost of money. Several relate their rates to the prime bank rate. Rates range from prime to prime plus 6%. Prime plus 1% to 2% is common for customers of average risk, but 4 of the 11 firms which provided rates indicated that they may, under certain conditions, go above prime plus 3% to prime plus 4.5%, 4.75%, 5% and 6%. Rates increase when the risk of default increases and they decrease for large loans since the investigation cost can be spread over a larger loan. Almost all commercial loans are being made at floating rates. When fixed rates are available, they are generally for short terms of 1 to 3 years and require a premium of about 0.5% over the current floating rate.

The loan-to-security ratio varies between 65% and 100%. Seventy to seventy-five percent is most common with higher percentages being reserved for the lowest risk customers.

A wide variety of convenants may be required although most agreements have few or none. Personal guarantees are frequently taken in addition to liens or mortgages on property. One lender requires quarterly financial statements. Several lenders occasionally require that shareholder loans not be repaid until their loan is repaid. A few mention working capital ratios or amounts, maintenance of voting control of the company, insurance on equipment or life insurance on the principals.

The most difficult terms to negotiate usually relate to the amount and cost of the loan. The interest rate and the amount of loan to security ratio were mentioned most fequently. Fees and convenants are also sometimes a problem, especially covenants requiring personal guarantees on the loan.

In general, the study concluded that the market faced by non-bank financial institutions is highly specialized and very competitive, with the chartered banks being the major source of competition. Most major NBFI's have field representatives who call regularly on present or potential customers in an effort to increase business. Competition for new business, high default rates, high administrative costs per dollar of loan and provincial legislation which protects borrowers, tends to force interest rates up even though the market is very competitive. These factors also inhibit the making of small size loans.

Sales Finance companies account for half the total term loans made by NBFI's, but their market share has been declining in recent years as a result of competition. Trust companies have not been very active in this market but some plan increased participation subject to legislative constraints. Credit Unions have, at present only a small fraction of the term loan market but this share has been growing rapidly in recent years.

While it appears that the NBFI's covered by the study (pension funds and life insurance companies did not participate) tend to take more risk than chartered banks, the survey of loan files indicated that most loans are made at rates which are lower than the chartered bank prime rate plus 3.5% and are on a floating rate basis.

The Supply of Venture Capital: The Thorne Riddell Study

In an effort to gain an understanding of the problems and opportunities with which the suppliers of venture capital believe themselves confronted, a series of focus group meetings were conducted in Toronto, Montreal, Vancouver, Calgary and Halifax. Most respondents characterized their investment philosophy as conservative and cautious. Respondents admitted making few investments over the course of a year, fewer than they would like to make.

Respondents also admitted that they have narrow expertise which results in referrals which may not be justified for sound business reasons; few investments in start-up or turn-around situations; lack of interest in many sectors of the small business community such as retail, service industry, and other non-manufacturing ventures. There is also a lack of interest in the high-technology sector, due in part to the fact that venture capitalists don't understand it, and in part to the perceived nature of high-tech enterprises. They are seen to require strong R&D support, highly developed manufacturing, marketing and management skills, and often small sums of money.

There was also recognition on the part of all respondents that the venture capital suppliers were not prepared to make small investments. Basically, they are not interested in investments under $100,000 due to the cost of investigating and processing a single deal, and the time and effort required to monitor the business.

According to respondents, one of the major difficulties the venture capital market has is identifying worthy investment candidates. Most small business operations were characterized as poorly managed and under-capitalized as well as being in the wrong place at the wrong time to allow for significant growth.

Respondents also felt that many small businessmen lack the very basic skills required not only to operate but to grow a company, and that general business acumen was at a low level. They found it difficult to have confidence in many of the businessmen who approached them. Small businessmen are also perceived to be poorly educated or trained in business management, most are unable to successfully put together a proposal or make an impressive presentation.

All respondents agreed that it is of primary importance to coax the real entrepreneurial talent out of the large corporations and into their own businesses. Such people, it was believed, have both the skill and the experience, and thus the best chance at success.

The overriding feeling about the venture capital market and government was one of unease. The suppliers of venture capital believed that government policies were not structured to assist them.

From the point of view of venture capitalists, the government should limit its role to tax policies -- those more favourable, of course, to venture capital investors -- but government should definitely not attempt to become a "partner" in the business environment. It should not attempt to play broker or middleman, or any other role as an interpersonal force between the demand side and the supply side of the small business sector.

FINANCIAL MARKET GAPS

Correcting Capital Market Imperfections as a Rationale for Intervention

As noted in the Analytical Framework section, one of the more frequently cited factors which motivates federal government financing support measures is the perception that there are imperfections or gaps in financial markets. These gaps are thought or perceived to exist with respect to smaller businesses. In attempting to assess the performance of private sector institutions and federal government programs with a view to suggesting changes which might make them more effective in the pursuit of the gap filling mission, it is essential to flesh out the concept of financial market gaps.

In economic terms (see "On Gaps in Capital Markets") the imperfections which can prevent the efficient allocation of resources fall into two categories. The first is a situation where markets do not clear at the prevailing price -- i.e. the interest rate does not adjust to equate demand and supply -- so that rationing by a means other than price is necessary. This is the type of gap most frequently mentioned in connection with business credit. It envisages a situation where there is a large, unsatisfied demand for loans by borrowers willing to pay more than prevailing rates but are prevented from doing so by institutional or other constraints.

The second type is a case where markets clear but at the wrong price. The price is not one which would prevail in competitive markets but one which is held artificially above or below marginal cost by tax distortions, tariffs, subsidies, monopoly or regulation. Of these causes, the most frequently discussed is monopoly type control of the credit market.

It appears to be generally accepted, in the literature on the subject at least, that the second of these categories exerts but a minor influence on business credit markets. The studies commissioned under the review also found that business credit markets were quite competitive. If significant gaps are to be found, the most fruitful area in which to search would appear to be the first category.

Empirical Gaps

The High Risk Gap

Dealing with the first type of imperfection, the study of lending practices of chartered banks indicated that banks were reluctant to make loans which required a rate of more than prime plus 3% to compensate for default risk and transaction costs. This would appear to create a gap wherein borrowers who are willing to pay higher rates will not find accommodation at chartered banks. Since the latter are the major source of funds for smaller businesses and since smaller loans entail higher transaction costs and default risk, this potential gap takes on added importance. The FBDB, acting as a supplemental lender, extends credit to those who cannot find the required accommodation at other financial institutions. Acting in this manner, the FBDB appears to be remedying a gap created by the reluctance or inability of chartered banks to price for default risk in excess of prime plus 3%.

A number of factors could account for the unwillingness or inability of private sector institutions to set a rate high enough to compensate for the additional default risk and transaction costs implicit in smaller loans. Chartered banks might believe that the required rate would be regarded as discriminatory and lead to investigations and regulatory action. The rate required might also raise the spectre of usury. The type of business associated with higher rate loans may also be unsuited to the operating style of the banks. Finally, lending officers may not be able to properly assess risk.

Other lenders may be unwilling to move into this market because of regulatory restrictions, or their organizations are not geared to handle the smaller, riskier transactions. The threshold size of organization (number of branches and so forth) needed to achieve the minimum degree of portfolio diversification may simply be too large for non-bank financial institutions to undertake, or the institutional framework needed for diversification is not in place.

While the fact that private institutions have failed to serve a given market indicates a possible basis for arguing that government should attempt to do so, it should also be demonstrated that the government can expect to avoid some of the resource and public relations costs which served to deter private entry. The circumstances which give rise to "market failure" may also give rise to "government failure".

To illustrate the issues involved in remedying this type of gap, suppose that there is a class of borrowers with a probability of default such that an interest rate of prime plus 3% is insufficient to compensate a lender for default risk and transaction costs - say prime plus 5%, is required. And suppose further that borrowers are willing to pay prime plus 5% but private financial institutions are unable or unwilling to charge such a rate. Then, if government enters the market to meet this unsatisfied demand and charges a rate of prime plus 5%, the gap is closed, and government is serving a segment of the market which for some reason the private institutions have avoided. An economic benefit results, and there is no subsidy.

If, however, the government cannot or does not charge a rate higher than prime plus 3%, the gap will still be closed, but the expansion of demand caused by the lower rate, together with the fact that funds are being offered below their opportunity cost, means that economic losses are generated. Available evidence suggests that the loss will, under most circumstances, exceed the economic gain that results from filling the "gap".

It follows that "gap" filling can justify an intervention which offers loans at a market rate which fully compensates the lender for the risk and transactions costs involved in the loan. If, however, the opportunity cost of intervention is not recovered from loan revenues, a subsidy is conferred on borrowers. The subsidy is not, in economic terms, needed to remedy the gap and must be justified on other grounds.

Fixed Rate Term Loans

The reluctance of chartered banks to provide fixed rate term loans to businesses has also created a temporary "gap". At present, the banks make term loans to businesses on a floating rate basis. With long term rates (3-5 year bonds) currently running 2%-3% less than short-term rates, the fixed rate loan is attractive to those who believe that short-term rates will not fall significantly. The attractiveness of a fixed rate loan under present interest rates is very dependent on the prepayment penalty demanded by the lender. Should the short term rates decline, as is suggested by the fact longer term rates continue to be lower, then the fixed rate borrower could suffer a loss unless the loan can be prepaid. The unwillingness and inability of lenders to hold borrowers to fixed rate contracts in the event of a significant decline in interest rates is one reason for a reluctance to offer such contracts under present conditions. Difficulty in matching borrowings and lendings is another reason. In addition, high and volatile interest rates have caused many savers to shy away from longer term instruments.

The reluctance of banks to provide fixed rate term loans could affect smaller businesses more in times of lower interest rates. If interest rates decline substantially, thus encouraging consumer demand and investment, smaller firms could be at a disadvantage unless they can obtain the lower rate loans on a fixed term and thus protect against sudden, future increases in interest rates. The chartered banks are aware of this need but would require more stable interest rates and the ability to match the maturity structure of their liabilities with the term of the loans.

"Excessive" Interest Rates or Security Requirements

From the observation that small businesses, especially new ones, face higher rates and more stringent security requirements than larger, more established enterprises, it is sometimes inferred that small businesses are "gouged" and that this constitutes a gap requiring intervention. Two possibilities can be distinguished. If the argument is that small firms should not have to pay a rate that covers the opportunity cost (including both risk elements and transactions cost) of a loan, then it is more a call for a subsidy than correcting a gap. On the other hand, if it is contended that small borrowers are being charged rates far in excess of their actual opportunity cost because of monopoly control of the credit market, then it is the monopoly that is the gap, and it is there to which attention should be directed and on which evidence should be presented. Merely pointing to different rates being charged borrowers of different risk is not sufficient evidence of the existence of a gap.

Transaction Costs

Some of the costs of processing a loan are independent of the size of the loan, and hence form a larger fraction of a smaller loan. In addition, a small transaction may require more careful screening for risk than a larger one, especially if the firm involved is new. For these reasons the transactions cost of a small loan will generally be a considerably larger proportion of the loan than will that of a large loan, a situation sometimes cited as a market imperfection. By itself, however, it is no such thing. A market can include costs which differ among customers, and the contention that small borrowers should not have to pay their transactions cost is really an argument for subsidies, having nothing to do with the filling of gaps.

Information Costs

In the traditional "perfect" market, complete information is assumed to be available at no cost. In reality information always costs something, and this may affect the operation of the market. The information cost that is important here is the cost of screening a loan applicant to determine the likelihood of default; it has been argued that this is a gap. But screening costs can be regarded as part of transactions costs, and the same argument as above applies.

Debt-Equity Ratio

Some studies have indicated that the debt-equity ratio rises with firm size, and concluded that small firms are being rationed in the acquisition of debt. That small firms are in fact less indebted than large firms is by no means clear from the available empirical evidence; indeed, some studies show just the opposite, but assuming provisionally that it is so, it does not follow that market imperfections are necessarily the reason. It would also have to be shown:

a) that the desired debt-equity ratio in small firms is at least as large as that in large firms.

b) that the actual debt-equity ratio is below its desired value in small firms and that this difference is due to rationing or discrimination, and is not simply a rational response by small businesses to relative costs of raising debt and equity that differ from those faced by large business.

Rural Borrowers

It has been previously noted that chartered bank branches are rather thinly spread in rural and remote areas, and hence small businesses in these locations are poorly served in their financing needs. The argument seems to have two components:

a) rural borrowers, in effect, have higher transactions costs than borrowers in the cities. If the argument is that they should not have to pay the extra costs of their loans, then it is, again, a call for a subsidy, not for filling a gap.

b) rural markets are "thin", lacking sufficient numbers of both buyers and sellers for proper market operation. A potential borrower may have only one commercial lender within reach, leaving open the possibility that the lender will exploit this local monopoly power. If the argument was backed by evidence, it could be considered as identifying a gap, which might justify intervention in the form of a supplemental lender which fully recovered the transactions costs (and all other costs) of doing business in the remote area. It is these costs, presumably, which lead private lenders to avoid the area in the first place. A failure to recover opportunity costs is a subsidy which should be justified separately.

Venture Capital

Where venture capital is taken to mean equity capital or loans which act as equity capital -- i.e. they participate in the risk of the enterprise, sharing the losses as well as the profits -- there are, as yet, few federal government measures which use the "shortage" of such capital as a rationale for intervention. Only the FBDB has an explicit program for making equity and equity type investments. To date, this is but a small part of the Bank's total activity and is more in the way of an experimental foray than a full-fledged program. The EDP has attached a conversion privilege to some of its guarantees but this is more in the way of an informal attempt to reward very high risk than an explicit effort to fill a venture capital need.

In the recent past, however, considerable effort has been devoted to structuring an explicit instrument (Venture Enterprise Investment Corporation) in response to a perceived need. While this effort did not bear fruit, the issue is still very much alive. For this reason, the review attempted to gain a better understanding of demand and supply factors.

The preliminary examination conducted by Thorne Riddell indicated that the issue must be approached with caution. Attempts to ascertain the need through surveys encounter the problem that the entrepreneurs who are most likely to need venture capital are not in business -- their enterprise is but a concept. Reaching this "market" will be difficult.

Again, the results of the survey will be dependent on the product being offered. In a sense, it is akin to testing the market for a new airplane. First one has to be designed and its major features and costs described. This proved to be the case in focus group meetings where the first question was invariably, what is venture capital? When it was defined in terms of equity participation, the reaction was negative. Most feared that independence would be threatened.

There are, at present, 58 firms which specialize in supplying venture capital and more enter each year. In addition there is a indeterminate number of individuals who, acting alone or in concert with others, provide venture capital for smaller enterprises. Over the past two decades, the increase in the relative price of housing has provided many entrepreneurs with a source of venture capital.

The focus meetings indicated that the kind of "product" offered by venture capital suppliers was a mixture of capital and expertise with a "hands-on" approach to their investments. Concerns regarding the safety of their investments tended to keep them away from high risk areas and most believed that the number of worthwhile investment opportunities was limited -- in some case due to a lack of expertise.

Weighing the perception of suppliers as to the prospects for profitable investments which also afford a reasonable degree of safety , together with the reluctance of entrepreneurs to prejudice independence, it is hard to avoid the impression of a limited and specialized market.

From the standpoint of public policy, concern over the availability of venture capital is twofold. If a shortage of venture capital prevents existing firms from taking advantage of profitable expansion opportunities then there is cause to consider measures to help overcome the shortage. Neither the examination of the financial characteristics of smaller firms nor the results of the surveys indicate that this is happening on any appreciable scale. Again, this type of need would seem to be the natural market for venture capital suppliers.

The second cause of concern is the case where the lack of a suitable venture capital product prevented entrepreneurs from entering areas where the federal government is most anxious to foster development: exports, innovation, import substitution, regional development. These are also high risk areas which venture capital suppliers tend to shun. Since neither the firms nor the suppliers of venture capital can appropriate the benefits which accrue to the nation as a result of contributing to these objectives, there is no real motive for them to undertake the added risks. Whether or not a lack of equity capital prevents entrepreneurs from entering these areas cannot be discerned empirically -- the "product" would first have to be defined.

THE ROLE OF FEDERAL GOVERNMENT PROGRAMS

Enterprise Development Program

In 1977, following discussions and interviews with more than 5,000 business persons in all regions in Canada (Enterprise '77), the Enterprise Development Program was established to replace the following programs:

- General Adjustment Assistance Program (GAAP)
- Automotive Adjustment Assistance Program (AAAP)
- Pharmaceutical Industry Development Assistance (PIDA)
- Program for the Advancement of Industrial Technology (PAIT)
- Productivity Enhancement Program (PEP)
- Industrial Design Assistance Program (IDAP)
- Footwear and Tanning Industries Program (FTIAP)

While EDP provides both loan assistance and direct contributions, of most relevance to the financing needs of small business is the guarantee part of the program, i.e., insured and protective insured loans authorized after April, 1977. A protective insured loan is one which is granted to protect a previous insured loan and usually entails a 100% guarantee as opposed to the normal 90%.

This part of the program is patterned after the adjustment assistance programs except that the focus shifted from that of assisting firms affected by reduced trade barriers to that of promoting economic development by guaranteeing all or part of the financing required by firms in manufacturing and processing industries which were in a high risk category but offer development potential.

The program is designed to provide 90% insurance for a loan obtained through the private sector at current commercial rates. An annual fee of 1% on the amount of the insured loan is charged by the lender, payable to the government on a semi-annual basis.

From April 1, 1977 to August 1, 1981, 541 projects were approved with an insured loan value of $446 million. Only 332 projects (74 a year) with a value of $266 million, were actually contracted. The remainder did not result in contracts following approval by the Enterprise Development Board because the amount of assistance was renegotiated, the project was cancelled or the firm went bankrupt. Approximately 60% of the loans insured were for either working capital or refinancing and most of the firms were located in Quebec and Ontario.

As at September 15, 1981 there was a total of $148 million of insured loans outstanding. Of this amount, $66 million (45%) was accounted for by 7 firms.

The size of insured loan has decreased from an average of $1.1 million in 1978 to $593,000 in 1981. The average loan contracted by the central board was $1.2 million, and the regional boards $140,000. These are relatively large loans by most small business standards. Even the regional board average, for example, is well in excess of the maximum loan allowed under the SBLA. Hence EDP tends to operate in the large end of the small business spectrum.

For the 3 year period 1977 to 1980 companies having less than $5 million in annual sales represented 80% of the total number of authorized insured loans and 36% of the total dollar value. Conversely, the larger firms having sales in excess of $5 million represented 20% of the total number of authorized insured loans but 64% of the amount authorized. Smaller firms (sales less than $250,000) account for 23% of loans by number but only 12% by value. The type of loan insured is very high risk: 32% of the authorized amount is subject to claims, receivership or identified problems. Of this amount, 13% is accounted for by the declared loss on Consolidated Computer Incorporated (CCI).

Since EDP's loans tend to be much larger than those of either SBLA or FBDB (although the average size has been dropping) there seems to be little likelihood that EDP competes directly with the other programs, except possibly in the loans authorized by the regional boards. The restriction of EDP to the manufacturing and processing sectors further reduces the scope for competition, since both FBDB and SBLA activity is heavily concentrated in the service and trade sectors.

In line with the structure of the program, the government assumes most of the risk in the event of default. The revenue from the insurance fee, however, is not sufficient to cover the government's liability. To the extent that the insurance premium does not cover the losses incurred and the program's operating costs, a subsidy is conferred. The following table provides an estimate of the subsidy.

Table 19

EDP	1977-1982*		
	($ million)		
	Central	Regional	Total
Authorizations	415.2	31.3	446.5
Actual Loans	247.7	18.1	265.8
Claims paid and formal demands	23.0	5.4	28.5
Fees Collected**	2.7	0.3	3.0
Net Claims Paid	20.3	5.1	25.5
Net Claims as a % of Loans	8.2%	28.2%	9.6%
Identified as Problems (August 1,1981)	56.4	0.8	57.2
Estimated Losses* **			
Estimated Loss as a % of Loans	22.8%	0.4%	21.5%
Actual & Est. Loss (%)	31.0%	32.6%	31.1%
Actual & Est. Loss ($) (Total Subsidy)	76.7	5.9	82.7

* To August 1, 1981.

** Distribution between Central and Regional Boards is estimated.

*** Estimated losses include claims paid plus identified problems.

The losses absorbed by the EDP following the sale of CCI account for a significant part of total losses under the program. If the guaranteed loans made to CCI under the EDP are excluded, losses (i.e. claims paid, formal demands and identified problems) on the remaining $224.9 million of contracted loans amount to $41.8 million or 18.6% of the portfolio.

In some cases the Central Enterprise Development Board has authorized loan insurance on the condition that the government receive an option to purchase shares in the company. Three such arrangements have already yielded a return of $12 million reducing the overall loss rate to 26.6% (13.3% excluding CCI). There are approximately 25 other cases of insured loans outstanding on which the government has an option which could result in additional gains. The realized gains reduce the estimated losses:

Estimated losses*	$ 41.8 million
Estimated gains	12.0 million
Net subsidy excluding administrative costs	29.8 million
Average yearly losses	6.6 million

* Not including CCI

In calculating the subsidy conferred under the guarantee portion of the EDP, account must be taken of administrative costs. It is difficult to obtain an accurate estimate of these costs since very few personnel devote all of their time to this program and particularly to the guarantee portion. Typically, the approval process requires time from personnel in various branches and divisions of the department.

The total subsidy conferred on the $59 million of net contracted approvals made in the fiscal year ended March 31, 1981, excluding administrative cost, is $15.6 million. Since most (60%) of the loans are for refinancing or working capital and since most of the losses incurred are 100% losses -- i.e. the insured loans were not secured or the security in which they shared was deficient -- it is possible that the position of the lending institutions might be enhanced as a result of EDP support.

The fact that the guarantee portion of the Enterprise Development Program affects very few firms (74 a year) and these firms tend to be large by small business standards and, because the program is restricted to the manufacturing and processing sectors, they are heavily concentrated in two provinces, suggests that the program plays only a minor role in remedying possible "gaps" in financial markets.

While it is clear that the clients served would not likely have been able to secure financing without a guarantee, it is difficult to ascribe this to imperfections in the lending markets. While the firms assisted offer some development potential they also tend to have a weak financial position, making the program more of a last resort "financing" for selected firms which present lending risks that private lenders could not be expected to assume. The need being served, therefore, would appear to be more in the order of venture capital than possible gaps in lending markets.

Small Businesses Loans Act

The SBLA program provides default insurance, on loans made by banks or other designated lenders to qualifying businesses. To be eligible for an SBLA loan, a firm must have sales of no more than $1.5 million. The maximum loan size at present is $100,000, raised from $75,000 in 1980. The purpose of the loan must be one of: purchase of fixed or movable equipment, alteration, construction, or purchase of premises, or purchase of land, and the firm must provide 20% of the cost of the project (10% if the project is construction or purchase of premises or land).

Lenders are required to follow "normal banking practice" with respect to evaluation of the borrower and security requirements. SBLA reserves the right to refuse to pay a claim on these grounds, and occasionally does so. Most (98.5%) of the loans guaranteed under the SBLA are made by chartered banks and the terms of the guarantee are such that it amounts to 100% guarantee up to the point where the total losses of a given bank (e.g. the Royal) equal 10% of the loans made.

Although the SBLA has been in existence since 1961, the bulk of the activity has taken place since 1978 when the Act was changed to allow a floating rate of "prime plus 1%". Following this change the amount of loans made each year rose from $96 million in 1977 to $408 million in 1980.

In June 1980, the Act was extended for two years and provision made to increase the lending ceiling to $850 million for the two year lending period ending June 30, 1982. In December,1981 the lending ceiling was increased to $1.5 billion.

According to the information gathered in a recent evaluation of the SBLA program and that developed in the "Wynant" study, the program is of greatest relevance to small firms in the retail and services sectors which account for 65% of all loans made under the SBLA. The median loan size is $17,000 and the median firm size is $180,000 of annual sales. Fifty-seven percent of all loans are made to firms located in Québec and British Columbia.

Most (58%) of all loans are made for the purpose of financing moveable equipment -- i.e. automotive equipment, portable store or restaurant fixtures. Other purposes include the financing of fixed equipment (11%), improvement of premises (12%) and purchase of premises (11%).

The number of loans made to firms in a start-up situation has grown from 21% of all loans in 1975 to 37% in 1979. Unincorporated firms account for 32% of new loans and there is evidence to suggest that SBLA loans are more likely to originate in smaller centres.

When the claims paid by the federal government during the period 1977 to 1980 are expressed as a weighted average of past loans (Table 20), it can be seen that the loss rate is rising as loan activity increases. The increased loss rate could reflect a tendency on the part of chartered banks to accept riskier loans under SBLA.

Table 20

	1977	1978	1979	1980
1. SBLA Claims Paid	632,794	1,380,584	1,788,619	3,825,688
2. Less Recoveries	7,287	13,808	51,633	62,036
3. Net Claims	625,507	1,366,776	1,736,986	3,763,652
4. Loans	96,447,226	176,261,912	258,631,119	408,398.256
5. Weighted Average of four previous years' loans($M)	69.0	83.7	115.7	175.2
6. Subsidy as a % of weighted average of previous loans (see above)	.91%	1.6%	1.5%	2.1%

Source: "The Implicit Subsidy in Federal Business Financing Programs" by Edward Hughes (Informetrica Ltd.)

In assessing the effectiveness of SBLA in remedying possible gaps in financial markets and whether or not it competes with FBDB loans, one of the key issues is whether the amended program results in loans which the chartered banks would not have otherwise made. The evidence which suggests that this might be happening is the fact that the loss rate is rising, and an increasing number of start-up situations are being financed. On the other hand, based on an analysis of loan application files (SBLA Evaluation) and a survey of chartered bank lending officers it would appear that most (80%) of the loans under the SBLA are of the type which the banks would have made in any event. In other words, the banks appear to be following "normal banking practices" in making SBLA loans.

The program has, however, had the effect of reducing the security required by the banks and resulted in a lengthening of the term of the loan. Some banks also use the program as a competitive tool to attract new business. These factors coupled with the tendency of SBLA loans to originate in smaller centres suggests that the main contribution of the program is that of encouraging the banks to offer better terms to smaller businesses, finance more start-up situations and assist managers in smaller centres to make term loans.

Given that most of the SBLA loans are of the type which the chartered banks normally make, only a small portion (perhaps 20%) of such lending could be regarded as competitive with FBDB loans. These would consist of the riskier loans (prime plus 3% and up risk category) and some loans which the managers in smaller branches would not have made without the SBLA guarantee.

The federal government, by paying the losses on SBLA loans and hence relieving the borrowers of the necessity of paying the default premium, confers a subsidy on the recipient firms. The amount was $3.8 million in 1980 but this can be expected to increase over time as a result of increased volume and a rising loss rate.

Small Business Development Bonds

The Small Business Development Bonds (SBDB) program was (it was changed in November 1981 to the Small Business Bond program) a temporary tax measure designed to reduce the interest costs of qualifying small business corporations by enabling them to obtain lower interest rates from banks and other financial institutions. Interest paid on an SBDB is treated as a dividend, hence banks and other financial institutions will not incur a tax liability on the interest received on SBDB loans. A financial institution that would otherwise pay income tax of about 50% on interest income should, as a result, be able to reduce the rate of interest charged on the qualifying debt by about one-half. The impact on borrowers is, however, somewhat reduced (except for corporations with no tax liability) by the fact that they cannot deduct the interest charges for tax purposes.

To qualify for an SBDB, the borrower had to be a Canadian controlled, private corporation eligible for the small business tax deduction. Substantially all of its assets had to be used in an active business in Canada and it, or associated corporations, must not have previously issued an SBDB. Proceeds from SBDB loans could have been used for:

- (i) acquiring land or new depreciable property for Canadian business use;
- (ii) financing Canadian scientific research and development expenditures;
- (iii) refinancing loans to the extent that they financed qualified expenditures made after December 11, 1979 and before January 31, 1982; and,
- (iv) assisting a small business in financial difficulty.

SBD bonds had to be for amounts not less than $10,000 and not greater than $500,000 and the loan contracted and the proceeds expended after December 11, 1979 but before January 31, 1982. The term was more than one year but less than 5 years. As well, the loan must be designated as an SBDB through a joint election by the lender and borrower and the election must be filed with Revenue Canada.

On the basis of discussions with lenders active in the program, it is estimated that approximately $2.4 billion of SBDB loans will have been issued before the program's scheduled termination date, January 31, 1982. The cost to the government in terms of foregone tax revenues is estimated (see "Implicit Subsidy in Federal Business Financing Programs") to be in the order of $80 to $100 million in the first full year of the program, depending on the tax position of the borrower. On the basis of a cost of $80 million the first year, the total cost to the government would be in the order of $200 million over a five year period.

The division of the subsidy between the lenders and the borrowers is sensitive to the rate of interest charged and the taxable income of the borrower. If the banks, for example, priced the majority of the SBDB loans at one-half prime rate plus two percent, the split would have been in the order of 5% to 15% for the banks and 85% to 95% to the borrowers.

As the program was designed to provide a measure of interest rate relief to borrowers obtaining financing from private financial corporations, it is unlikely that it would compete with the higher risk loans which FBDB makes as a supplemental lender. On the other hand, the SBDB could be used in conjuction with the SBLA and the EDP. At this point in time, there is no data available to indicate to what extent the program is being used jointly with the SBLA. To date no EDP guaranteed loans have been issued under the SBDB.

Up to January 22, 1982, 10,925 bonds with a total value of $1.639 billion had been registered. The lending institution is required to register each bond with Revenue Canada within 90 days of issuance. Based on this data, the bonds were used mostly for the acquisition of machinery, equipment and buildings (73%) and land (16%). The average size of loan was $124,000 indicating that the program is most relevant to firms in the $1-$5 million annual sales range.

The attractiveness of the program varies with the level of interest rates. When the prime rate is 12% the average small business would be charged 14% for a term loan. The "out-of-pocket" cost to those businesses which have a marginal tax rate of 25% is 10.5%. The "cash" cost of a bond, based on a price of one-half prime plus 2%, is 8% since the interest is not deductible. When the prime rate is 20% the cash savings to the firm is 4.5%. While the bond thus had an interest rate cushioning effect for taxable small businesses, it also tended to encourage them to expand at a time when high interest rates were dampening consumer demand and investment generally.

In November 1981 the program was renewed for another year and modified to include unincorporated firms. The provisions were also changed to orient the program toward firms which were experiencing difficulty because of the impact of high interest rates on their cost structure.

Credit Insurance

The government announced its intention to introduce a credit insurance program in March, 1979. Credit insurance, like mortgage insurance, is a risk spreading technique whereby the loss on one or a small number of loans and/or equipment leases is absorbed by the payment of a small, self-supporting insurance fee by a large number of borrowers. It is intended to encourage the large pools of institutionalized savings such as pension funds and insurance and trust companies to provide term debt financing to smaller companies which are unable to offer securities in public debt markets. With the exception of selected real estate investments, these institutions have shown little inclination to provide financing to small business in Canada.

The objective of the program is to encourage the formation of specialized credit insurance firms in the private sector by providing a reinsurance facility. The program is to be self-financing through a sharing of the insurance fee between private insurance companies and the government in accordance with expected losses to be underwritten by each party. Government insurance support is a temporary measure pending market acceptance of the credit insurance concept and development of private credit insurance firms. In this respect there is provision for review of the need for the program after ten years.

There is no minimum loan size. The program stipulates that loans in excess of $5 million would not be eligible. It is expected that the average size of loan under the program would be considerably larger than the majority of FBDB loans. As well, since the program is designed to attract the longer-term pools of capital into business term lending it has a focus somewhat different from existing government financial support programs.

The program is in the development phase. One company has received its licence, a second is in the process of making application to government and other private sector groups have expressed an interest in forming credit insurance companies.

The Federal Business Development Bank

The Changing Market Niche

In 1944 the federal government created the Industrial Development Bank to assist in the development of enterprises in Canada by making term loans. While other entities subsequently entered this field, (e.g. RoyNat in 1962) the Bank was the leading player and virtually pioneered term lending to small and medium-sized businesses in Canada. The market niche served by the Bank was made possible by the fact that chartered banks were effectively limited in making term loans.

In 1975 the FBDB was formed to replace the IDB and the Bank's mission was changed to broaden the scope of its activity by providing management counselling, management training, information and advice as well as financing. The new Act also instructed the Bank to "give particular consideration to the needs of small business enterprises". The Bank was also encouraged to take more risk. Pursuit of the mission was, however, constrained by the need to charge "reasonable" rates of interest and by the fact that, as a schedule D Crown Corporation, the Bank was expected to operate without appropriations. In pursuing its revised mission, the Bank established competitive interest rates for smaller loans which were lower than those charged for larger loans. By the end of fiscal 1980, the Bank's loan portfolio had doubled in size with much of the increase attributable to smaller, riskier loans.

While the Bank was so engaged, changes were occurring in the market place which appear to have dramatically altered the nature of the clients served by the Bank. As noted above, the chartered banks were expanding their term lending activity with the fastest growth taking place in the small size loans. Foreign banks entered the market, credit unions and caisses populaires increased business lending and other term lenders expanded.

Following the amendments to the Small Businesses Loans Act in 1978, lending under this program accelerated rapidly. During the four year period ending October 30, 1981, new lending under SBLA totalled $1,244 million compared to a total of $597 million of lending during the previous 17 years. In December 1980, the Small Business Development Bonds program was launched and it is estimated that some $2 billion of term loans have been made under this program to December 31, 1981.

The events noted above suggest that the market niche that the Bank was initially structured to serve has been shrinking steadily and, on the basis of current trends in capital markets, may continue to shrink although there will likely continue to be a supplemental role for the Bank. The information developed to date concerning the financing needs of small business and the supply arrangements which exist to meet those needs suggests that the kind of business available to the Bank as a supplemental lender will likely consist of small loans in the high risk class and some loans to firms in rural areas. Serving such a niche presents problems in that default losses and transaction costs tend to be high and it may not be possible on "fairness" grounds to charge rates which would cover the cost of handling this business.

The analysis of the lending practices of chartered banks also indicated that they were reluctant or unable to provide term loans to businesses on a fixed rate basis. The FBDB does, however, offer fixed rate loans. Whether or not this can be taken as evidence of a "gap" in the term loan market requiring government intervention to remedy depends, in part, on the conditions attached to such loans. In essence, the borrower is gambling that longer term rates will not decline significantly. If they do and the borrower is committed to pay the higher rates over the contracted term then the borrower suffers the loss. Where the penalty for prepaying the loan is such that it pays the borrower to incur the penalty and refinance the loan at a lower rate then it is the lender which suffers a loss. Should longer term rates rise and approach equality with short term rates, the attractiveness of fixed rate loans declines accordingly.

Of more importance to smaller businesses which are dependent on chartered banks is the availability of fixed rate loans in times of lower or stable interest rates. Should interest rates decline, thus stimulating consumer demand and encouraging investment which had been postponed due to high rates, then the lack of a fixed rate instrument could place smaller firms at a disadvantage. They will not be able to fix the cost of funds over a period of time and hence protect themselves from sudden, sharp increases in interest rates.

The Present Niche

A recent examination of FBDB lending reveals that activity is concentrated in three industry sectors - retail, hotels and restaurants and manufacturing. Based on the Economic Council sample of the FBDB portfolio, more than 50% of FBDB loans by number are for working capital and financing ownership changes and much (34%) of the Bank's lending is to finance start-ups. The average term of FBDB loans is longer than term loans of chartered banks and the average profitability of FBDB clients appears to be generally lower than industry sector norms. In addition, the number of loans to existing customers as a proportion of total loans is increasing.

The distribution of the FBDB portfolio coupled with the losses experienced suggest that it is the instrument which is most relevant to the possible "gap" areas: smaller, riskier loans and start-up situations and most of its loans are made in sectors where the bulk of the smaller firms are found: retail trades, hotels, motels and restaurants.

The FACSYM survey indicated that the FBDB had the highest degree of visibility in that the small business community was much more aware (by a margin of two to one) of the FBDB than any other federal government program. The Wynant study indicated that the FBDB played a major role in providing financing to those whose loan requests were turned down by the chartered banks. The fact that very few of those whose requests were declined by chartered banks were ultimately unable to find financing is due in part to the role played by the Bank as a supplemental lender.

The Wynant study also noted that:

- the Bank provides higher risk loans than chartered banks and undertakes more analysis of loan applications;

- the relationship between the FBDB and the chartered bank varies dramatically. The majority of chartered bank branch managers interviewed were confused about the role of the FBDB;

- most FBDB loan decisions (90%) are made at the branch.

- more than half of all credit enquiries do not develop into formal loan applications;

- FBDB placed much less emphasis on collateral than chartered banks. Reasons cited: most applicants (90%) are chartered bank customers and available collateral is already pledged;

- few of the chartered bank managers interviewed looked at FBDB as a competitor;

- FBDB placed less emphasis on loan quality than chartered banks in evaluating the performance of lending officers. The number of loans granted as opposed to loan losses were of primary importance in assessing the performance of lending officers.

Implicit Subsidy

Estimating the annual subsidy (see the "Implicit Subsidy in Federal Business Financing Programs") conferred by FBDB on its loan customers must take into account its role as a financial intermediary. This rules out measuring the subsidy in terms of the value of public and private investment and consumption which must be foregone (the social opportunity cost of government outlays) as a result of the loans made by FBDB.

Nor is the amount of the subsidy simply the annual loss incurred by the Bank. In making its loans, the Bank operates at a 10/1 leverage ratio. For each dollar it loans, 91 cents is borrowed and 9 cents comes from the government's equity investment which is maintained at a level required by the 10/1 ratio. Although the Bank is not required to earn a return on this investment, the equity ($222 million at the end of fiscal 1981) is not "free" in an economic sense. It has an opportunity cost -- i.e. the funds could have been devoted to other uses. If, for example, the government used the funds to retire debt, the annual saving to tax payers at current interest rates would be in the order of 15% or $33 million. In estimating the subsidy, the weighted average social opportunity cost of funds (14%) was used to price the equity portion of the Bank's loans. Had the equity been priced to realize the before-tax return of a private sector lender such as RoyNat, the applicable rate would be 24%.

The Bank also has an advantage in that it can borrow funds as an agent of the federal government. This enables the Bank to borrow funds at a lower cost. The advantage amounts to approximately one-half of one percent. Since this advantage is not available to firms which borrow from lenders who pay market rates, FBDB clients enjoy, albeit indirectly, a subsidy occasioned by the use of a government -- i.e. taxpayer -- guarantee. The appropriate measure of the cost of borrowed funds is, therefore, the 5 year weighted average corporate bond rate.

Following this procedure, the subsidy implicit in FBDB lending activity for fiscal 1981 was $95 million. This amount is expected to decrease in future years as the provision for loan losses decreases.

The Cost Recovery Plan

On January 1, 1981 the Bank initiated a Cost Recovery Plan (CRP) the objective of which was to adjust the Bank's lending strategy in an attempt to recover operating costs on its portfolio of new loans. In essence, the CRP calls for reductions in the smaller, riskier loans by tighter screening procedures, increased security requirements and fewer loans for working capital and refinancing purposes. At the same time, interest rates were increased through the introduction of risk differentials. While the CRP envisages that the interest rates being charged will not cover the cost of making the smaller, riskier loans, the losses on this class of business are expected to be covered by the earnings from larger, less risky loans. If the CRP targets are met, the Bank expects to be on a break-even basis by the end of fiscal year 1983.

Critical to the achievement of CRP objectives is the ability of the Bank to adjust its size (number and size of its branches, number of people) to the volume of business available to it as a supplemental lender. Estimating this volume is difficult since it depends on a number of factors: relative interest rates; loan conditions; loan policy (reducing the number of loans made for working capital or refinancing purposes, for example); the level of interest rates; the state of competition in the term loan market; general economic conditions.

Some idea as to the impact of these factors can be formed by examining recent experience. Prior to June 1979, the Bank charged a lower rate on smaller loans than it did on larger loans. The rate charged was also very competitive. By November 1979, the Bank's rate equalled that charged by others and, over the next few months, rose to a slight differential. In October 1980, the Bank also began to implement elements of the CRP -- risk differentials, tighter screening, fewer loans for working capital. The effect of these measures is reflected in the sharp decrease in net loans authorized. Volume decreased from a net of $686 million in fiscal 1980 to $336 million in fiscal 1981 (April 1, 1980 to March 31, 1981). The decrease was largely confined to the smaller loans: loans of less than $100,000 fell by $229 million while those between $100,000 and $500,000 fell by $137 million. During this same period, SBLA loans increased from $259 million to $459 million.

As an offset to the reduced volume of smaller, riskier loans and as a source of revenue to cover the losses on such loans, the Bank, in its CRP, envisages an increase in the volume of larger, lower risk loans. This segment of the market is very competitive and volume will likely be very sensitive to the rate of interest charged, loan conditions and the level of interest rates.

While the full effect of the CRP on the Bank's volume of business is difficult to forecast, it is apparent that there is considerable excess capacity at present and this condition is likely to persist for some time.

It should also be noted that even if the Bank recovers its accounting costs -- i.e. breaks even in accounting terms -- there is still an element of subsidy arising from foregone tax, foregone return on equity and the borrowing advantage of the Bank. On a portfolio of $ 2 billion, the estimated annual subsidy is $54 million.

The Primary Mission May No Longer Be Tenable

While the bank provides services such as management counselling and makes equity investments, its primary mission is that of making term loans to smaller businesses, thus constraining it to the smaller end (authorizations less than $5 million) of the term loan market. The Bank is also constrained to operate as a kind of basket under the term loan market. What falls into the basket is that which has passed through a sieve of private sector financial institutions. Its business is, in a sense, that which the private sector regards as unprofitable. The Bank, however, is expected to serve this business (whatever the volume might be), charge "reasonable" rates and not lose any money.

At one time this was possible. When the Bank had the business term loan market virtually to itself, enough "good" business was generated to enable it to make a slight profit. During that period, the Bank was also under pressure to be less conservative in its lending practices. With the removal of the regulations which created the original niche, the Bank has faced strong competition for the "good" business and, because it is not supposed to compete, has been relegated to the more and more risky, high transaction cost segment of the market. Accelerating this trend has been the assistance given to private sector institutions to enable them to more fully service the smaller end of the term loan market: the SBLA, SBDB and EDP guarantees and provincial measures.

Under these conditions, the task the Bank is attempting to perform is at least heroic if not impossible. In adjusting to the reality of the market place, it is difficult to avoid the conclusion that either the Bank's mission must be changed or the constraints relaxed or both.

Tax Measures

Another way in which the cash flow of small businesses might be improved relative to that of big businesses is to offset any "unfair" treatment accorded small business by the tax system. The tax system may be regarded as "unfair" to the small business sector if members of the latter pay higher taxes on a given net income, that is, face higher effective tax rates, than do larger business. An analysis of inter-sectoral and inter-size class differences in effective tax rates reveals, first, whether the tax system is "fair" and allocatively neutral and, second, whether, other things being equal, measures which encourage additional small business activity will make the best use of the nation's resources.

The small business deduction is a credit against corporate tax payable which is available to Canadian controlled private corporations with active business income. The deduction is 21% of the first $150,000 of taxable income for each company or associated group of companies (except when the cumulative deduction account is close to the total limit of $750,000). The November 1981 Budget increased these limits to $200,000 and $1 million respectively.

Table 21 reports, by sales class, the proportion of firms that paid no income tax at all in 1977. Obviously these firms paid no taxes because they had no taxable income. The important question is whether they made use of all the credits and allowances available in order to attain their tax-free status. The analysis indicates that they did not. For all but the largest size class, net cash income was negative. These firms attained tax free status without using their capital cost allowance and any tax deduction for which they were eligible.

Non-taxpayers in the largest size class reported positive net cash income but, after taking some or all of their capital cost allowances, inventory deductions and losses carried forward, were able to report zero taxable income. These firms did not use any of the small business deduction to which they might have been entitled.

The findings have a number of implications. First, for a significant majority of the smallest firms, there can be no question of unfair taxation since they pay no tax.

Secondly, for the non-taxpayers before and after-tax returns are the same. These firms must be earning lower before-tax rates of return than tax-paying firms. They are therefore making relatively poor use of the resources at their disposal.

Thirdly, the majority of the smallest businesses and a significant fraction of businesses with annual sales revenue under $25 million make no use of either capital cost allowance or the small business deduction. Changing these measures will not induce this group of firms to change their behaviour in any way. The majority of the smallest incorporated businesses simply remain untouched by changes in the capital cost allowance or the corporate tax rate.

As Table 21 indicates, the difference in the effective tax rate paid by the largest and smallest size classes averaged over all sectors is approximately 10 percentage points. If the small business deduction were eliminated the effective tax rate paid by the smallest businesses would, on average, exceed the effective tax rate paid by the largest businesses by about three to five percentage points.

Table 21
All Industry
Firm Size in Annual Sales

	Under $250K*	$250K to $500K	$500K to $1.5M	$1.5M to $5M	$5M to $25M	$25M+
% not paying tax	60.5	42.3	37.7	37.3	35.7	28.9
Effective tax rate on book profits with small business deduction	20.9	19.5	24.5	30.7	34.1	31.2
Effective tax rate on Book Profits without small business deduction	32.1	30.5	35.4	35.0	34.4	31.2
Capital Cost Allowance as a percentage of Net Cash Revenue	14	19	23	26	24	30
Dividends as a percentage of Net Cash Revenue by those not claiming small business deduction	10	20	19	20	14	
Dividends as a percent-of Net Cash Revenue by those claiming the small business deduction	10	7	7	9	7	
Manufacturing and Processing Deduction as a percentage of taxable income	.4	1.0	1.5	1.9	2.4	2.2

* K = 000

This result varies from industry to industry, in some cases the small business deduction is insufficient to equalize the effective tax rates of the largest and smallest size classes. In other cases it is not necessary at all. For most, however, three to five percentage points would appear to have been sufficient to assure the smallest size class of an effective tax equal to that of the largest size class.

There is an indirect subsidy implicit in the Small Business Tax Credit. Figures for 1981 are not yet available, but if a simple extrapolation of past values is taken, the total small business credit in 1980 amounts to about $950-$1,000 million. Not quite all of this goes to "small" business, since any firm whose accumulated deduction account is under $750,000 is allowed to claim the credit on the first $150,000 of taxable income. The total credit going to large firms is, however, negligible.

FINANCING PROBLEMS AS A RATIONALE FOR SMALL BUSINESS POLICY: SUMMARY AND CONCLUSIONS

The first-hand evidence gathered through surveys, interviews and focus group meetings failed to indicate a major financing problem which could be attributed to the failure of capital markets or federal government measures. Most respondents (90-95%) were able to obtain the needed credit from private sector financial institutions or through a federal government measure -- mostly the FBDB. Most obtained their long and short term financing from chartered banks, most preferred to deal with banks and most (91%) indicated they were served adequately or very well. Very few respondents required additional equity capital in the three year period preceding the FACSYM survey. Those who did, obtained the needed amount from shareholders -- the preferred source. The focus meetings also indicated a low perceived need for equity capital and a pronounced reluctance to raise equity capital if it meant prejudicing the entrepreneur's independence.

Even though the FACSYM survey was conducted during a period when interest rates were reaching historic highs, financing was not ranked as the most important concern. Day to day operating problems far outweighed financing in importance, with the smallest firms citing a shortage of skilled help as being most important. While the surveys indicated areas where the banks and other financial institutions could improve their performance, the one area of dissatisfaction which gives rise to concern is the perception that security requirements are excessive.

The surveys, however, focussed on the Canadian-owned, independent segment of the small business population and cannot be interpreted to say anything about the needs of self-employment firms. Also the nature of the samples is such that the firms in a start-up situation or located in rural areas are under-represented. The surveys should not, therefore, be interpreted as reflecting the perceptions of these firms.

The examination of supply side factors indicated that since the removal of lending restrictions in 1967, the chartered banks have become increasingly active in the business term loan market. They now account for some 47% of all term loans of less than $5 million in size and the smaller size loans (less than $200,000) are the fastest growing segment of this portfolio. The 1978 amendments to the Small Businesses Loans Act and the introduction of the Small Business Development Bonds in 1980 added to the growth of smaller term loans.

The entry and rapid growth of foreign bank affiliates added to competitive pressure in this market. At the time the review was conducted, there were some 98 affiliates operating in Canada and they had captured an estimated 3 percent of the small, term loan market. Following the 1980 revisions to the Bank Act, 47 subsidiaries of foreign banks have received permission to operate as financial intermediaries. This number is expected to increase, maintaining some competitive pressure. At the same time RoyNat, the largest of the non-bank term lenders' expanded rapidly. While sales finance companies have been affected by the increased competition, they are second only to chartered banks as a source of term credit. Provincial government agencies are also very active and are expected to be increasingly so.

As sources of future competitive pressure, the Credit Unions have become increasingly active. Some Mortgage and Trust Companies plan to enter this field and each year there are more Venture Capital Companies with larger pools of funds to invest. When the federal government's Credit Re-Insurance program becomes active, further pressure will be exerted through tapping pension and life insurance funds which to date have not been active in this market.

One manifestation of these changes has been a progressive lowering of the spread between the lenders' cost of borrowed funds and the selling price -- i.e. the rate charged to customers. In the early '70s a spread of 7-8% was not uncommon. Now, spreads of 2-3% are more the order of the day.

The examination of the performance of chartered banks failed to find evidence to indicate that banks treat their smaller business loans in a manner which differs substantially from that accorded larger firms. While the Wynant study found that smaller businesses paid a premium of 40 basis points (4/10 of 1%) after allowing for risk, the premium was justified by higher transaction costs per dollar of loan revenue. Similarly, it was found that collateral requirements placed on smaller firms was more stringent than those placed on larger firms. This was justified in terms of the dependence of the firm on the health and capability of the owner and the recovery rates in cases where default had occurred. The evidence presented, however, is not sufficient to preclude further concern.

Since the sample of loan application files included firms with annual sales of less than $100,000, and since there was no apparent discrimination by size of business, there is no reason to suppose that these firms experience more difficulty in obtaining bank financing than the larger firms covered in the FACSYM survey.

The Wynant study brought to light other practices which indicate the possibility of a "gap" which would affect smaller businesses. The reluctance of banks to provide high risk loans -- i.e. those where the risk of loss on default is such that a rate in excess of prime plus 3% would be required -- is the one which is of most importance. Included in the category of high risk (not "bankable" at prime plus 3%) loans are: start-up situations; long maturities (more than 10 years); inventory loans; loans for equity purposes; industries in trouble; cash flow loans. The ability and experience of managers in smaller branches is also of concern but this is primarily a matter of training and improved organizational practices. A reluctance or inability to provide fixed rate loans could put smaller businesses at a disadvantage when interest rates decline and signal new investment.

Non-bank financial institutions account for some 35% of the relevant term loan market and offer a variety of loans which both compete with and complement chartered bank activities. Sales finance companies tend to specialize in asset loans and take on more risk than banks. RoyNat tends to specialize in cash flow loans that depend more on the ability of the firm to repay rather than just the value of the assets pledged as security. While chartered banks also look to the ability of the firm to repay, the loan decision is heavily dependent on the value of the collateral -- especially in the case of smaller firms. Mortgage companies, of course, specialize in financing business properties.

Taking the broadest possible view of what may constitute a gap in term credit markets, the possible areas are high risk loans, start-up situations, firms in rural areas and fixed rate loans. The measures which the federal government has in place appear to cover these situations. The FBDB in its role as a supplemental term lender makes high risk loans in the areas that banks tend to shun (start-up situations, industries in trouble, cash flow loans, specialized assets) and most of its loans are made in sectors where smaller firms are found. The default rate incurred on this type of business does not suggest a need to expand the supplemental lending activity. On the contrary, the weight of available evidence suggests that the market niche available to FBDB as a supplemental lender has shrunk and will likely continue to shrink. While it is difficult to forecast the volume of business available to the Bank as a supplemental term lender, the experience of the last two years suggests that it is well below that which the Bank is geared to handle.

Although it is relevant only to firms in the manufacturing and processing sectors, the guarantee portion of the EDP is oriented to very high risk situations. The SBLA encourages the banks to finance more start-up situations and specialized assets. It is especially relevant to the smallest firms and is widely used by managers in smaller branches. The Credit Re-Insurance program should open up sources of fixed rate funds that can be channelled into fixed rate loans and help alleviate any problems in this area.

Regarding venture capital, there was a clear indication that suppliers tend to shun small businesses and high risk areas. The FACSYM survey and Thorne Riddell study did not, however, indicate a serious need on the part of established "Independent" firms. If there is a shortage of venture capital which prevents existing firms from expanding, it would have to be found in the self-employment segment of the small business population. Start-up situations are another matter. Without a clear definition of what venture capital product is being offered, there is no practical way to ascertain need. The major policy issue in this area is the desirability of structuring a risk-sharing instrument to encourage entrepreneurs to enter the high risk development areas.

Excepting those firms whose financial problems reflect the normal functioning of competitive markets and the normal risks of enterprise, it is difficult to avoid the conclusion that, with the measures the federal government now has in place and with the increasing attention paid to the financing needs of small business by private sector financial institutions, most small businesses are reasonably well served. Not perfectly -- there is still room for improvement -- just that a major financing problem which could be attributed to the failure of private sector capital markets or federal government measures has not been identified.

Each of the measures examined to this point seeks to improve the flow of funds to small businesses primarily by making term loans easier to get and at lower cost. Behind these measures is a belief, possibly rooted in history when restrictions on bank lending kept them out of the term loan market, that private sector institutions create or allow gaps to exist which affect smaller businesses. Each of the possible empirical gaps has been examined from the standpoint of economic theory which suggests that subsidies are not needed to correct the perceived gaps. Indeed, theory suggests that providing loans or guarantees at prices below their opportunity cost can lead to "over-shooting" the gap and result in a wastage of resources. Each of the measures does, however, result in a subsidy being conferred on the client firms. Funds must be raised by the federal government to keep the measures in operation.

Since "gap filling" alone does not justify the subsidies, it is important to look at the ultimate purposes of the intervention: economic and social goals. In pursuit of national economic goals, there are a number of reasons why the federal government might wish to subsidize smaller businesses. Entrepreneurs cannot appropriate all the benefits which accrue as a result of more innovation, increased exports, reduced imports and improved regional distribution of economic activity. These activities also expose the entrepreneur to much more risk than pursuit of the more familiar, local, regional or national markets. To encourage the desired activity, the federal government will have to share the risk -- either through subsidies or some other manner. The question then is whether or not the array of existing instruments can or do encourage smaller businesses to undertake the desired activity. This requires an exploration of the linkages between capital subsidies, small businesses and economic objectives.

ECONOMIC DEVELOPMENT AS A RATIONALE FOR ASSISTING SMALL BUSINESSES

In most cases, government measures designed to ensure that small businesses obtain the funds needed to fulfill the aspirations of the owner to establish, maintain or expand a business, entail a subsidy: there is a transfer of funds from tax payers to the recipient firms. The subsidy can take many forms but usually has the effect of lowering the cost of capital or increasing the after-tax return to capital or entrepreneurial capacity. The subsidy can be provided by differential tax rates; differential treatment of income and expense items for taxation purposes; lending at rates which do not permit the recovery of the opportunity cost of funds employed; grants; guarantees which require funds to administer and cover defaults. The value received for the subsidy can be measured in terms of improved economic performance or an increased quantity of a public good -- i.e. achievement of social goals such as the fostering of entrepreneurship -- or as an improvement in social welfare through an income transfer.

If the government's desire is, in effect, to purchase more economic performance with the subsidies, then one question which emerges is: can economic performance goals be better achieved by targeting policy measures on the basis of the size of firm? National economic performance is often defined in terms of regional development, employment, exports, import substitution, innovation, R&D, competition and so on. The importance attached to benefit: cost analysis in recent years also indicates that the efficiency of resource allocation is increasingly being taken into account. A second question is whether or not subsidizing the cost of capital is likely to produce the desired quantitative results. In attempting to answer these questions it is useful to first look at the role of small business in contributing to quantitative economic objectives.

Contribution to Employment Goals

The small business community plays an important role in the Canadian economy. Determining the nature and extent of that role and how it changes over time is, however, a difficult problem. Statistics Canada publishes few statistics which relate economic activity to firm size. This should not be interpreted as a lack of concern on the part of Statistics Canada, only that the interest in the distribution of economic activity by firm size is relatively new and the problems associated with this are immense. Indeed, the limited data regarding the nature and characteristics of the small business community presented in this paper would not have been possible without the expert assistance of the Business Statistics Division of Statistics Canada. Other statistics which have been cited from time to time are plagued with methodological difficulties which make interpretation difficult. Much more research is needed to produce reliable statistics concerning economic activity and the size of firm -- (see "Problems in Estimating the Quantitative Contribution of Small Business").

One of the more important economic goals is that of employment creation. One of the more frequently cited statistics is that which originates in a U.S. study conducted in 1979 by David Birch of the Massachusets Institute of Technology. Using Dun and Bradstreet data, Birch studied the process of start-up, growth, decline and death of U.S. firms, and concluded: "The results tell a clear story. On the average about 60 percent of all jobs in the U.S. are generated by firms with 20 or fewer employees. Large firms (those with more than 500 employees) generate less than 15 percent of all net new jobs."

The story becomes a little less clear when we consider another of Birch's findings: that it is not in small businesses per se that new jobs appear, but rather in young businesses. More than three-quarters of all new jobs in the period studied were in firms less than four years old. Almost all of these are small firms, and this appears to be the reason for the apparent superior performance of small firms. Although Birch did not address the question directly, it appears that mature small firms had no particular tendency to create jobs at a higher rate than mature large firms.

It is of some interest, though not perhaps very surprising, that new jobs generally appear in new firms, rather than through expansion of existing firms. Every job in a new firm is a new job, and every job lost is lost from an existing firm, so we would expect figures on net new jobs to be biased toward new firms. Some other factors might help to explain the phenomenon:

a) Entrepreneurs seldom start new businesses in declining industries; rather, they select growing industries which offer the best hope of profits. On the other hand, an existing firm in a declining industry may not be able to transfer itself into a more attractive line of business without incurring substantial costs. Since new jobs appear in growing industries and old jobs are lost in declining ones, we would again expect the net-new-jobs figures to contain a bias toward new firms as a proxy effect for inter industry differences.

b) if the average firm size in declining industries is bigger than in growing industries, this will strengthen the proxy effect mentioned above. For example, if a shift in public taste produces a declining market for television sets and an expanding market for restaurants, then jobs will be lost from large established firms (electronics manufacturers) and will appear in small, and often new, firms (restaurants), again biasing the net-new jobs figures.

Such effects are part of the normal dynamics of supply and demand, and indicate no special job-creating power originating with the size of firm alone. Whether these and similar factors suffice to explain Birch's findings is a question that was not addressed in the study. A check which might have been made, but apparently was not, is to look at the figures on job loss. If most new jobs are in new firms, then in view of the high mortality rates for young firms (Birch found that only about a third of new firms survive their first four years) we might expect a substantial portion of jobs lost to be in new -- and hence small -- firms.

Canadian data sources are also ambiguous. The figures in the publication "New Statistics on Small Business" yield the following:

Employment by Firm Size

Firm Sales ($000)	1972	1978	Change 72-78
0 -50	413,945	383,581	-30,364
50 -250	844,831	791,750	-53,081
250 -2000	1,182,139	1,356,406	+ 174,267
2000-over	3,246,202	3,707,742	+ 461,540
All Firms	5,687,117	6,239,479	+ 552,362

The two smallest size classes show a substantial decline in employment over the period, while the two largest classes show a large gain. At first glance, then, these figures seem to contradict Birch's findings. However, the results are distorted by inflation: since the sales-class boundaries are fixed in dollar terms, the larger firms in each class will be "promoted" by inflation into the next higher class, even if no real change takes place. In order to correct for this distortion, it is necessary to increase the class-boundaries at the rate of inflation over the period. For example, the $50,000 boundary in 1972 should correspond to $87,000 in 1978. As the the boundaries were not adjusted in this way, it is difficult to draw conclusions about the effect of firm size on growth in employment.

Using Statistics Canada data on employment also presents problems since data is collected on an establishment basis and an arbitrary limit of 20 employees is used to describe small business. The employment data published by Statistics Canada does, however, show that during the period 1976-1980 employment in the service producing sectors increased more rapidly than in the goods producing sectors, with the former accounting for 82% of employment growth. Most of this growth took place in the community, business and personal service sectors in which large numbers of small businesses are found. Overall, those sectors where Canadian-owned, independent firms dominate business activity are also those which exhibit above average growth in employment.

The observed differences in growth rates of employment between the goods producing sectors and the service sectors could reflect, in part, a change in the composition of GNP which, in turn, reflects new technology, changing tastes, demographic factors and increased real income. The nature of these sectors is also conducive to the formation of relatively small establishments.

Another way to form some idea as to the relative contribution to small business to employment is to compare the growth rates of employment and real domestic product in the sectors where small businesses (as defined in the "Profile") dominate activity with those dominated by large businesses. In total these sectors accounted for 25% of real production in Canada and 36% of total employment. Growth rates are as follows:

Employment: Average Annual Growth Rates

	74-75	75-76	74-76
Small Business Dominated Industries	2.7%	1.6%	2.1%
All Industries	1.1%	1.4%	1.25%

Real Domestic Product: Average Annual Growth

	71-76	76-80	71-80
Small Business Dominated Industries	5.7%	1.7%	3.9%
All Industries	4.8%	2.4%	3.7%

(Because of data limitations the list of Small-Business dominated industries for Employment differs somewhat from that for RDP).

It will be noticed that the employment figures show a somewhat higher rate of growth in the small-business dominated industries than in the economy as a whole, for the two year period 1974-76, while the figures for RDP (which, within an industry is a reasonable proxy for employment) show little difference in growth rates between industry groups over the decade. In particular, the RDP figures suggest that if there has been a notably more rapid growth of employment in small firms than in large, it must have been at the expense either of profits or of productivity, as, for example, by a shift in output into more labour-intensive industries. Some individual industries, of course, do show much greater than average rates of growth, while others post declines.

Similarly, an examination of the sectors dominated by small businesses indicated, that, in total, the contribution of these sectors to exports was in the order of 2%, not including sales to foreign tourists. Available data did not permit a reasonable estimate of the latter. The limited data available on R&D expenditures also indicated that large firms dominate activity.

The profile of small business suggests that, since self-employment firms account for only three percent of business sales, policies directed toward this group will have only a marginal impact on any of the aggregate economic performance measures. On the other hand, independent incorporated firms account for 39 percent of business sales. In exploring the linkage between public policy toward small business and the achievement of aggregate economic goals it would seem most fruitful to focus on the latter group.

An examination of the sectors in which independent, incorporated firms are concentrated (retail trades, construction, miscellaneous wholesale, miscellaneous services to business management) indicates that the subsidization of new capacity in these sectors is unlikely to yield more exports (save for the expenditures of foreign tourists), less imports, or more innovation. The major hope for the achievement of government economic performance goals would appear to be in the area of increased employment.

The nature of the sectors in which small businesses are found suggests that any employment opportunities which are created would have special relevance to the segments of the labor force which exhibit the highest rates of unemployment: unskilled; youth; unprotected (non-unionized). Programs which have the effect of inducing new firms to enter, existing firms to expand or which prolong the life of severely troubled firms would appear to offer some hope of contributing to the achievement of employment goals.

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