Profitability and Cost-Oriented Incentives to Industry

Working Group C
August 13, 1976

PROFITABILITY AND COST-ORIENTED INCENTIVES *

(other than Group B)

REINVESTMENT CREDITS AND RESERVES

as

INCENTIVES TO INDUSTRY

REPORT OF WORKING GROUP C

August 13, 1976

* See page iv Explanatory Notes for description

Incentives Working Group 'C'
Profitability, Cost and Reinvestment Incentives

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K. Appendices:

P R E F A C E

Members of Working Group 'C' were the following:

Fletcher, R.G.	-	Program Evaluation Division
Gagné, E.R.	-	Quebec Regional Office (Incentives)
Harman, D.F.	-	Economic Development Analysis Division
Kayes, S.B.	-	Operational Planning Division

The approach followed in carrying out the analysis and preparing the report took into account a number of factors which need not be elaborated on at this time.

It was considered that the four Working Groups would be preparing an overall report for the Directors of Incentives to use in whatever manner the Directors wished.

While the overview report is to take the form of an executive summary, it was considered desirable to make the report of Working Group 'C' usable as a separate reference document as well as being a back-up document to the summary report.

"Strategy for Development - Incentives to Industry?" is therefore included as a "setting" paper at the beginning of the paper.

The other parts of the report are prepared in a way which will permit the Directors and others (to whom Directors wish to refer the report) to examine the report from their particular point of view. Accordingly, some of the material has been set forth in appendices in different depths and more technical language for whatever reference is desired.

It is recognized that the paper is somewhat longer than might otherwise be desired, but it was felt that the particular subject merited some special development because of both the merit and problems associated with profitability-oriented incentives.

EXPLANATORY NOTES

P.C.R. Incentives - this short form is used to refer generally to profitability incentive, cost-oriented grants other than on capital cost and jobs, and reinvestment credits or grants.

Profitability Incentives - are incentives which vary or depend on profits being achieved, e.g., grant equal to 50% of book profits; tax exemptions and credits.

Gap-estimated Incentives - are incentives which are based on the specific estimate of the inducement required to attract a firm. The specific amount finally paid may vary marginally according to some standard measure such as fixed assets or jobs.

Distinction

The distinction is made here between these two types of incentives because they differ in conceptual approach and performance. The profitability incentive tends to involve a sharing of risk and profit based on a broad appreciation of the probable order of need, inducement, etc., while the gap-estimated type of incentive tends to involve a more specific estimate of the return on investment and equity being generated from a specific plan.

Cost-oriented Incentives - other than the current RDIA incentives which are the responsibility of Group B - involves a sharing of costs in projects where the degree of estimates is less probable than for a gap-estimated incentive.

Capital Cost Allowance Privileges - for simplicity sake, throughout the report it has been assumed that normal capital cost allowance privileges are enjoyed. (Currently the RDIA grant paid results in the reduction from the capital cost allowances of assets of an amount equal to the grant.) If no change were to occur on the treatment of CCA, then an adjustment to any of the figures would be required, of course.

The policy for regional economic development should essentially be one of a non-rigid nature. While very major objectives are reasonably identifiable, the period to period, year to year, and indeed month to month changes in attitudes of the partners and competitors for development make it imperative that elasticity be one of the most important features of the various strategies and tactics employed to realise upon the opportunities available for development.

The foregoing should not be interpreted as diluting the need for major development thrusts. Nor should it be susceptible of falling back onto as an expediency approach. Rather the policy must have a cardinal feature of constancy of overall approach with a resiliency and capacity to use the human and physical resources available to a high degree.

The recognized heart of development policy is a joint Federal-Provincial approach to the identification of high priority strategies for the various regions of the country. It would be unwise for any approach of such importance to underplay the role of Government, but it would likewise be folly to under-emphasize the role of the private sector in such activity.

One of the principal roles for the private sector is to participate in the examination of the feasibility of priority opportunities identified by Government. This is a sound approach. However, it does not use the potential of the private sector to the degree which the private sector can, and should, play. Marshalling of the private sector's potential can be further accomplished by the presentation of a set of mechanisms and tools which are at once attention-catching and attention-sustaining.

The previous regional development industrial programs have been aimed at a non-directive role. In such they have been correct. At this stage it would appear desirable to increase the directive content without Government being heavily directive. This can be accomplished by the Government identifying that it wishes private enterprise to play a more forceful role in identifying and developing the economic opportunities for a more significant part of the economic thrust of regional development policy. In this way the energies as well as the latent capability of private enterprise to analyze the opportunities available in the different parts of the country can be brought into play.

Put in more illustrative terms, under the GDA approach the two Governments may identify three or four priority economic objectives, which they will then proceed to analyze for development, and the feasibility of which they will determine in co-operation with invited sectors of private enterprise. This takes a great deal of time and effort, as it whould. It also merits focussed attention by the Governments and the specific enterprises concerned.

It does leave many other aspects unexamined - simply because there are not sufficient resources available to consider all the alternatives. The latter would be gross extravagance. However, within each industrial sector or entrepreneurial group there are initiatives being exercised by the firms concerned in order to identify the opportunities for each to improve or to hold its competitive position. It then becomes a matter of attracting a certain amount of the "search-and-find" energies of these firms. Certainly, it is not desirable to take a disproportionate share, but it is important to harness a reasonable capability for the designated regions.

Historically these energies are concentrated on the most obvious growth centres, including resource centres which have a capacity for exploitation and development. What is appropriate is to develop within our set of strategies a set of stimulants which will, by their attractiveness, attract a certain amount of entrepreneurial interest. The correct balance between these more private-oriented initiatives and the more public-oriented initiatives is difficult to establish. Further, it is probably not desirable to over-concentrate on finding the balance. It is more important to set the stage for the momentums to be built up to a reasonable pitch and for the modification of the shares and rôles to be exercised for each region as well as nationally as the situation evolves. This is particularly so, since the overall setting is an international one.

Nothing suggested here should be interpreted as being more important than a set of international and national policies, but it is obvious, of course, that a set of international and national policies have to take into account an appropriate share in human and other resource development of a sub-national nature. Accordingly, the improvement of the systems for the interplay of these various forces is very desirable.

The specific improvement suggested for Canada at this time is that, while the energies of the public sector should be aimed principally at the development of long-term economic restructuring, a very important rôle should be established for the private sector. It appears clear that some increased stimulation of interest is necessary. It appears equally evident that gapestimating incentives have an important rôle to play. But it is also rather obvious that a somewhat more dynamic setting must be established. In this the role of profitability incentives can be particularly useful. The approach is not without its faults and its dangers. These are evident to the inexperienced

as well as the experienced eye. But the need to excite to a reasonable degree the imagination and capability of the private sector is considered as demonstrated. What is also necessary is that the stimulation and realisation of such endeavours must be undertaken in such a way as to use a reasonable amount of the resources available in a progressive way over a period of years.

The profitability incentives proposed herein have the potential to stimulate initiatives which, handled with careful restraint, can make a positive contribution to regional economies at reasonable cost without undercutting national and international activities (and relationships).

RECOMMENDATION

Three types of the profitability, cost and reinvestment incentives are preferred.

The three are shown below in descending order of preference. Perhaps as useful as any single type would be the combination referred to as (d).

(a) A profitability grant which is calculated as a percentage of the profits before tax. It is considered to be the best of these incentives for very selective use on projects which would not otherwise be attracted by the general grant and loan guarantee system.

(b) Cost-based grant calculated as a percentage of a labour bill is a useful incentive, where it is extremely difficult to anticipate certain costs and particularly labour-related expenditures over a period of years.

(c) Reinvestment Incentives as a percentage of Approved Capital Cost or of profits (before tax) may be used for a range of industries including manufacturing for either general or specific stimulation.

(d) Combinations of #1 and #2 with conventional grants may be particularly useful in select instances.

EXECUTIVE SUMMARY

Report on Profitability, Cost and Reinvestment Incentives

Policy Objectives

- A number of the high priority objectives of the incentives program can be met through the provision of profitability, cost and re-investment incentives. The other more normal objectives of the program should not be met by those types of incentives - but rather should be accommodated by other incentives considered by Group B.
- The profitability incentive can serve primarily as a special purpose incentive, used primarily for larger projects with significant economic impact which meet high priority objectives of the incentives program, applied for any of the eligible industries.
- Cost incentives can be used only very selectively for major projects with a high priority objective.
- A combination of these incentives with the Group B incentives can be very effective.
- Has special potential as a federal instrument which can supplement or substitute for joint federal-provincial instruments, if provincial problems prevent their application.

Advantages of Incentives

- *(1) Profitability Incentives*
- Attracts and holds entrepreneurial interest better and is more flexible for longer term programming than traditional gap-estimating incentives (more ROI/ROE related).
- Being based (primarily) on profits it has the most appeal to major industries.
- Similarly, it enables business and government to share the risk and gains.
- Overcomes some of the problems of judging the precise amount of incentive required where probability is too uncertain.
- *(2) Cost Incentives*
- Useful where a cost element is too uncertain.
- Is lower costing than a pure profit incentive.

Advantages of Incentives (Cont'd)

- (3) *Reinvestment Incentives*
- As a tax credit has many of the strengths and weaknesses of tax credits.

Disadvantages of Incentives

- Profitability incentive presents problems for determining sales revenues and costs, especially in interbranch and other non arms-length transactions.
- Adverse publicity in Canada can result from misunderstanding of the incentive since even informed people misjudge the need for profits, especially regarding preferred activities which might locate elsewhere.
- Higher administration costs.
- Long term involvement with firms is not desirable normally.

Types of Activities

- New industries to an area should be the principal use for these incentives; "second" firms in a relatively new industry should be considered where the scale and scope of the new venture is entirely different from that of the first entrepreneur in a specific industry.
- Multiphase projects which require a heavy overhead facility (management services, common componentry, with additional phases or related projectes whose undertakings can extend over a number of years).
- Investment programs of firms, the full scope of which can only be identified in principle at the outset, thereby permitting the progressive building of additional components or projects.
- Competitive instrument for use against other countries' and provinces' inducements
- Experimental activities.

Preferred Types

- Grant based on book profits, with or without guaranteed floor "and ceilings", is the type of incentive with most potential, but for very select use.
- Cost based grant, based on 3-4 years labour bill, is the second preferred incentive.
- Reinvestment credits can be used more broadly for a number of industries.
- A very strong preference is a combination of the profitability grant or cost-based grant with a gap-estimate incentive.

Features - *General*

A number of different features are highly desirable in order to meet regional, industry, and other requirements. These features should be available in a number of different combinations, thereby ensuring that the program provides enough flexibility to ensure the attraction of high priority projects. Subject to such constraints as are necessary to limit excessive benefits, entrepreneurs will endeavour to utilize their best resources in order to maximize profits.

- *(1) Profitability Incentive and Combinations*

- Base period for application of incentive extends over a number of years (approx. 8 years). This ensures more consistent interest in the undertaking, facilitates regeneration of taxes and company benefits, and is necessary because of deferred receipt of benefits.

- Rate of profits varies by industry, and a single rate is not appropriate. Objective should be to split tax: profit 60% to company and 40% for taxes, or 50-50.

- Ceilings will be desirable usually to limit excessive benefits.

- Floors or guaranteed minimum may be sought in exchange to give earlier benefit or as a safety device.

- A practical tool will be a combination of a gap-based incentive which provides earlier payment and a profit-based incentive providing stronger inducement.

- *(2) Cost Incentives*

- Labour costs are most practical element on which to base incentive.

- Period of application approximately four years to be meaningful.

- Level of incentive should not exceed 30% of labour costs to avoid inefficiency.

. Features

- *(2) Cost Incentive - continued*

- Combination of incentive based on capital costs and labour cost incentive could be attractive in major cases where non-availability of qualified labour force in a highly technical industry could create cash-flow problems during the initial years of the project due to high staff turnover and excessively greater labour costs.

- *(3) Reinvestment Credits*

- When used to supplement or bonus multiple undertakings, the reinvestment credit can be given as a percentage of ACC and/or wage bill. (Alternately, if a grant based on profits has been awarded the undertaking, the bonus could be based on profits.)

  These alternatives would provide a more sustaining thrust with a minimum of administration.

- When used as the principal incentive the reinvestment (or investment) credit useable only against profits of the project would tend to focus on profitable activities for the regions. This could be particularly useful for any new program initiatives respecting primary or tertiary industry.

Constraints

- *(1) and (2) Profitability and Costs*

- Determination of income and costs requires care, skill and equitable treatment; not technical "Tax Act" interpretations, making it desirable to have DREE administer grants.

- Complications and operating constraints necessitate sparse use in a number of cases for only priority objectives.

- *(3) Reinvestment Credits*

- Firms must attain a sufficient level of profitability in order to be able to use the reinvestment credits. (This can be overcome with a reinvestment grant.)

Impact and Cost – *(1) Profitability and (2) Cost Incentives*

- Significant new industrial initiatives of a priority nature will be experienced as a result of the greater involvement of the private sector in the incentive to industry program.
- Participating enterprises will have a sustaining influence on regional activity.
- Incentive costs will be higher for priority industries but lower then for some GDA activities.
- Administrative costs of profitability and cost incentives will be significantly higher, and such costs must be added to the "contribution" or direct incentive outlay.
- An uncertain cost element is represented by the competitive reactions which could be generated if the program were improperly used - other countries could quite rightly challenge any immature use of the incentive.
- *(3) Reinvestment Incentives*
- No impact or cost has been estimated because of the wide range of options.
- This estimate could be provided later with a clearer focus of the specific use to which the incentives would be put.

Implementation – *(1) Profitability and (2) Cost Incentives*

- Certain staff will require specialized training in order to (a) negotiate; (b) administer the special profitability and cost incentives.
- Close consultation with Industry officers will be necessary.
- *(3) Reinvestment Incentives*
- Would not require very special adjustments; a tax incentive would need interface with Revenue Canada, the degree of interface varying with the type of approach taken.
- If a reinvestment grant were to be provided then estimates would have to be made for budgeting purposes. Consideration could be given to establishing a fund rather than having annual budgeting.

A. Assumptions and Conclusions

1. Assumptions

A number of assumptions were made by the Group prior to undertaking the work program. None of these has changed as a result of the work subsequently undertaken.

(1) Long term economic objectives are included in the perspective for the next phase of development incentive planning. While the perspective is one extending into the 15 to 25 year framework it is considered appropriate to seek legislation which would make the incentives package available to the department for a minimum period of 10 years.

(2) The "open" character of the legislation would permit regulations and guidelines to be developed and modified throughout the period in such a way as to carry out the diverse objectives of the various regions and areas and to accommodate variations in the planning spectrum from time to time.

(3) The principles of complementarity between the most directive programs of the department and what are called the more responsive or enterprise-initiated activities are recognized as of critical importance.

It is assumed that the General Incentives Program of the federal governments should play a stronger role in involving private enterprise in economic restructuring, particularly respecting industrial restructuring. The order of emphasis might involve industrial incentives being responsible for 25 - 30% of DREE budget.

(4) It is assumed that the broad nature of incentives planning should accommodate the service and primary sectors as well as secondary industry.

(5) It is considered that the expectation of improved performance by incentive instruments and the increasing accent on the need to justify requests for funds against the competition of other competing demands will make it important to emphasize the measurability of performance of incentive programs.

(6) It was anticipated that as a result of the foregoing it is most likely that the high "volume" type of incentive (i.e., most A and B size cases) would be one which is oriented along the lines of those incentives examined by Group B, at least insofar as manufacturing and processing industries are concerned.

2. General Conclusions - Policy Objectives of PCR Incentives

(a) Relationship of profitability incentives to the overall incentives program within regional development policy.

To obtain a stronger involvement of the private sector in regional industrial development, it is essential to develop mechanisms and tools which will attract and hold the attention of the private sector. Entrepreneurs and managers cannot be expected to go against the normal momentum of established attitudes, habits and economic structures, which tend to favour going where their or competing business is well established - unless there are compelling inducements.

One of the best means of inviting enterprise's participation is the provision of stronger and more versatile incentives for selective application. These special incentives should be keyed particularly to longer-term developments. Many 'one-shot' or single project type of investments tend to be located where a firm has its existing facilities or where the competition is. In many instances it is just not worth the time

of a firm to look at potential locations outside of the mainstream of activity. However, if undertakings are multi-phase or have the potential to be followed by other projects which could make use of the management "overhead" services of the first, it becomes worth the time and effort to look at a number of alternatives which would not otherwise be examined. Suitable incentives which could be available for the longer term could gain the fuller attention of enterprises.

Profitability grants, cost-oriented incentives and reinvestment credits or grants have the capability to stimulate greater interest and sustained participation in an area.

Grants which are based on profits appeal to business and if reinvestment features are included the attention of majors can be obtained. For the activity with the very uncertain cost element that is dependent on other activity which may or may not transpire the provision of a cost based incentive can fill the bill.

If the degree of profitability is most uncertain then a combination of a more conventional grant and a profitability grant can be used or a guaranteed minimum can help to lighten the risk.

Where the degree of profit can be forecast with greater accuracy the more conventional capital and job based grant can be used.

It has been estimated that the current programs render support which is normally equal to in the order of several percentage points of operating costs p.a. over a plant's economic life. Clearly, this is insufficient to attract many new types of industries to an area which would not otherwise proceed on their own at some time in the not too distant future. Such a level is useful in affecting timing and scale decisions. To give a stronger thrust for a more meaningful number of new industries, different to those already established in an area, would normally call for a significantly heavier order of incentive.

However, the profitability-oriented approach involves potential technical problems of determining in an equitable fashion what is an appropriate level of profits. This is both complex and sensitive and as a result a good deal of work is involved in arriving at reasonable conclusions. As well, the dangers of conflict with the entrepreneur are very real and this requires the adoption of a restrictive approach to the use of such incentives. The same holds true for cost-oriented incentives, even though one of the parts of the equation, namely the income side, is not required to be determined - although it is necessary to take into account the "order" of sales in order to ensure that costs are related to the sale and the relevant time period.

In view of the foregoing, the incentives are considered to merit a very special role in the overall incentives spectrum, accommodating the following types of objectives:

(1) changing industrial structures of regions and areas
(2) reinforcing key structures of regions and areas
(3) inducing more higher risk taking and profitable ventures
(4) encouraging cost-sensitive undertakings
(5) simplifying the measurement of inducement at the decision taking stage
(6) to restrict pressures from overly optimistic entrepreneurs, especially in industries which are easily entered by new aspirants

Commenting briefly on the foregoing aspects:

(1) structural changes - involving the change of the economic and industrial structure of an area through the inducing of new industries and in certain circumstances, the reinforcing of existing industries which eventually can strengthen in a very substantial way the achievement of a stable industrial structure. Achievement of these priority goals may best be accommodated by the provision of incentives which have longer-time periods during which the firms can evolve a stronger thrust in an area. Of particular note are ventures which have a series of phases to them, the first of which will only achieve optimum viability as the second and third phases are introduced. In this context there is a specific role for profitability-oriented incentives and investment reserve measures have a potential role to play.

(2) Projects where profitability is particularly sensitive to cost changes can be accommodated through cost incentives.

(3) Projects on which uncertainty prevails about the suitability of the inducement that (where the Department is unable to conclude the amount of incentives which are probably appropriate to trigger a favourable decision by the entrepreneur) these can be accommodated by an incentive where both the Government and business share both the risk and the payoff. This ameliorates some of the delicacy of important decisions on major cases where it is essential to bid for the industry, (but not at an excessive cost) while still avoiding the danger of the decision by the business to locate elsewhere if the first negotiating position of the Department is considered inadequate.

(4) Higher risk projects, the compensation for which risks should be a higher payoff. These can complement more marginal activity attracted to the area. It is expected that in a number of unusual instances an entrepreneur will be prepared to take the higher risk if there is a commensurate opportunity for gain. In priority situations therefore the profitability incentive can be useful.

(5) To restrict riskier ventures, such as in a number of service industries, where entrepreneurs are notoriously optimistic and the economic circumstances are fraught with the troubles of bad decisions, e.g. tourist activities. A profitability incentive would tend to scare away some of the gamblers.

(6) Cost offset inducements can be provided where it is important to relocate an operation from one location to another, being most desirable to minimize adjustment problems. The cost of effecting the adjustments can be shared by the Government and the firm insofar as the establishment of the original facility and its personnel are concerned (the new facility can be established on more traditional incentives usually).

It will be seen that the aforementioned incentives have a very meaningful role to play within the overall set of incentive programs. It would seem that the merits outweigh the problems of determining operating costs, revenues and the contentions arising with applicants and the public who may understandably not fully appreciate the sophistications of the risks involved.

(b) Range

Long-term and medium-term types of ventures will probably constitute the principal prospects covered by profitability, cost and reinvestment incentives. This means that a more meaningful and sensitive role can be played by the incentives program in achieving the overall objectives of regional development. The priority industries and sectors which are identified for preferential treatment tend to fall into these time perspectives, and it is in these fields where the incentives would be principally applied.

Nevertheless, short-term projects with a potential for the longer term require particular attention, as well as the "restrictive" type of incentive, associated with the service industry and perhaps certain of the primary industries which are susceptible to inducement by profitability and cost related incentives.

(c) Types of Activities

It is possible to illustrate types of activities as follows:

- Undertakings of a multiphase nature, including volumic phases,* filling out a line of products, or new lines and especially catering to those enterprises with investment programs.
- a series of projects which may be reasonably committed, if anticipated obstacles can be overcome, such as the development and maintenance of a new and stable labour force, of the supply of raw material, of the development of efficient transportation facilities with reasonable access, and the opening of new markets. The provision of a profitability and cost mixture of incentives can provide the thrust required to win the entrepreneur over.
- ventures with heavy locational feasibility costs, high "overhead" services, very demanding management needs, etc.
- projects whose economic impact will take place over the short-term but where it is necessary to limit the risk involved and to maximize the ROE

The policy objectives of broadening the industrial target spectrum are not fully covered in this paper because of time constraints. Primary consideration has been given to the manufacturing and processing industry as it is still the best target. Nevertheless, it has been concluded that it is necessary to broaden the industries to be encouraged and it has been tentatively concluded that the profitability incentives would be particularly effective, whereas the cost-oriented incentives would be too expensive because of the excessive optimism of persons with respect to the service industry and the limited capital needed to enter some industries.

* modernization and volume expansions would not be included normally

3. Preferred Types of Incentives

To accommodate the aforementioned objectives, it is felt that a package of incentives from which the most appropriate could be selected is most desirable. For the major ventures the profitability incentives would be a meaningful alternative to capital cost based incentives.

It has been concluded that a Grant would be preferable to a tax credit but probably one of the most effective approaches would be a combination of a grant based on profits and a grant based on capital costs, with or without guaranteed minima or ceilings.

4. Summary - Strategy for Development of Regional Industry

The strategy for regional development of industry must involve a strong role for private enterprise. The very specific directive activity under GDA's must be complemented by a new program of incentives which have the capability to also involve the private sector in a very forceful way. The identification of this long-term partnership in development should be clearly signalled so that enterprise plays a more vigorous role in searching out the potential of a number of the designated regions.

The availability in the incentives package of several instruments which have a potential use for activities progressively introduced or expanded over the better part of a decade is an effective and forceful way of assuring enterprise that the search and pursuit of opportunities in the designated region is worthwhile. The fine tuning of the incentives to the particular set of investments which are stimulated by the approach should enable the development initiatives unearthed to be realised in a meaningful number of cases.

The very focussing of attention on the regions through these sets of development strategies should facilitate additional interest from other members of industry and commerce which would not otherwise be forthcoming in the highly competitive world of today.

It is concluded that the selective employment of profitability and cost incentives is well merited for the next phase of regional economic development in Canada. The judicious use of such incentives for very selective application should minimize and outweigh the costs and problems involved in paying higher incentives and administrative costs. PCR incentives can compel a higher level of attention of enterprise against other competition in Canada's drive for a fairer distribution of sounder economic growth.

B. Types of Profitability, Re-investment and Cost-oriented (other than Group B) Incentives.

The types of incentives examined are listed here together with one or two key conclusions drawn respecting their use. Elaboration of some is included in this report, while time and space have made it necessary to minimize reference to others.

1)	Tax rates	- Not really within context of this review but less desirable than an individual incentive.
2)	Tax credits	- Useful, but with drawbacks making them, on balance, less desirable than grants.
	Grants on profits	- Very useful for select purposes; relates to the profit motive and has attraction re focussing attention for L.T.; admin. complex, sensitive and operationally costly;
3)	Tax allowances	- Useful, particularly for certain tertiary industries; although utility rendered uncertain by frequent use in national system.
4)	Cost-oriented	- Useful for very select purposes, especially if costs are uncertain at least in S.T. wage base for 3 to 4 years preferred; Transportation costs important but complicated.
5)	Re-investment: -credits -reserves	- Very desirable and practical - Desirable but premature at outset.
6)	Equity	- Ownership not desirable for volume cases; preferred shares may be useful but doubtful except for large projects and international competition.
7)	Venture capital	- Worth inducement via tax credits.
8)	Special cost offset adjustment	- Very desirable; either Group B or C grants or both.
9)	Combos	- Probably the most useful is an ACC grant to limit risk and a profitability grant to induce fuller participation and growth over longer term.

B. (1) Regional and Area Tax Rates - Income Tax and Sales Tax

"Regional" income tax rates could be applied either generally as a Federal tax rate for a province - e.g., Newfoundland 35% versus Canada 40% for business - or specifically by class of industry, with individual cases being approved. An alternative of a special tax rate for selected industries in selected provinces could be applied either

(a) generally to all projects within the aforementioned categories, or

(b) specifically to those projects which either meet a number of standard conditions or are approved specifically as meeting identified policy objectives for such a program.

Dealing with the first item mentioned, over a long period of time it is conceivable that preferential income tax rates could be advantageous within or outside an incentives system. This is particularly so because of the disadvantageous rates in some of the provinces. However, in the short run such a practice would be very expensive since many windfalls would occur for the businesses already established and, of course, for some of the new businesses which are not incremental.

If regional income tax rates were tailored to apply on to those entrepreneurs who were new to an area this could be beneficial; however, the opposition to this approach would be very vigorous by other members of the region. Insofar as existing businesses are concerned, there would be a problem of establishing revenue "companies" in order to determine which new

activities should draw the preferred tax rates. While this latter approach can be useful it is probably more appropriately dealt with through the mechanism of incremental grants or tax credits.

The same general argumentation applies to sales taxes where once again disadvantaged provinces tend to have higher sales taxes which present obstacles to investment.

In brief, the transfer payment system is designed in part to provide a subsidy to the have-not provinces which enables them to keep their tax rates more competitive. It therefore is highly questionable whether regional tax rates of the federal government would be suitable. If consideration is to be given to this aspect, it is felt that it should be more suitably dealt with as a major aspect of regional developmental policy over and beyond the sphere of investment policy currently under examination.

Turning to the specific industry treatments, while it is considered that approaches could be dealt with under this section it is assumed that it would be more appropriate to consider such treatment under the types of incentives referred to as Tax Credits, notwithstanding the special rate already provided for in manufacturing throughout Canada as contrasted with other sectors in general.

B. (2) Tax Credit or Grants Based on Profitability

Definition: Tax credit on profits is used in this section to mean a credit against tax liability based on profits achieved whether calculated on profits before tax or taxable income. When calculations are used they refer to profits before tax unless otherwise specified.

A number of varieties of tax credits exist such as the "holiday" of 100% exemption from income tax, a credit consisting of a certain number of percentage points, or a credit based on some profit factor. A tax credit based on investment cost, etc., is discussed under reinvestment credits.

Tax holidays are considered to be good for certain types of activities, but in Canada the unique situations are so few that the disadvantages significantly outweigh the advantages.

A tax credit of x% extended over a period of years is considered as being quite a useful instrument for possible inclusion in an incentives package, particularly for certain industries, or where a meaningful volume of cases (by number) is involved, and where the delicacies of the Income Tax Act are outweighed.

However, it is the grant calculated on profits which is considered to be the best all-round profitability instrument. The grant is a more reliable measure for most entrepreneurs, especially new foreign companies and small firms, to look at rather a complicated Income Tax Law probably involving several departments. While the determination of eligible profits presents formidable problems it is considered better to have only one department exercising the judgement even if many principles are the same.

Detailed discussion is outlined elsewhere.

Profitability grants are considered to be particularly beneficial for the longer and medium term objectives identified earlier. The types of grants and their levels can be selected on the basis of the industry, product types, location, other factors of location, and

level of inducement considered appropriate to the particular project or set of projects. It is considered that individual decisions on the rate of incentive would be preferable to establishing standard formulae since (a) the nature of profit-taking and profit-making varies widely between types of project, firms, industries, location (See Statistical Appendix) and (b) only large projects are involved.

A number of typical rates of grants have been developed for illustrative purposes and are included in Appendix I. Here several useful examples are appropriate.

The provision of a grant of 15% of profits (before tax) over 8 years to a firm with a profit ratio of 10% of sales and a sales to capital cost ratio of 5:1 would provide a present value - p.v.* - in the order of 30% of capital cost. If capital investment per employee were $30,000 the incentive would be $10,000 per direct job.**

A grant of 20% of profits would provide a p.v.* benefit of 32% of capital costs for a project with a 40% profits to sales ratio, and a ratio of sales to capital costs of 1:1.

A guarantee based on the cost of fixed assets may be useful for some ventures where profitability prospects are particularly uncertain and a firm wishes some limit on its risk. Conversely, a ceiling on profits per job would reduce excessive payments.

Combinations of grants based on (a) profitability and on (b) capital costs could be effective. In certain instances the firms would prefer to receive part of the inducement in cash prior to when profits are finally achieved. This has the effect of reducing the overall risk of the entrepreneur as well as improving his cash flow. From a government point of view this option can have some appeal since it will probably be a useful offset to the Government's inclination to introduce ceilings in certain cases in order to curb excessive profit-taking.

* p.v. represents the present value of the incentive discounted to time of acquisition of the assets. (Assumes no loss of CCA benefits)

** All figures herein assume no deduction for CCA unless otherwise specified.

Multiphase operations and particularly major investment programs involving an early commitment of major "overhead" outlays such as energy pollution and other production facilities, plus heavy transportation costs during early periods before volume build-up, are particularly important for combined incentives.

While consideration was given to the advisability of graduating the share of profits no firm conclusion was drawn - i.e., grant of 50% of profits till benefits reach $x.0 million or $20,000 per direct job, after which the grant reduces to 35% of profits.

It is considered that it may be appropriate to quote the grant in terms of profit before tax and depreciation thereby showing a lower percentage for cosmetic purposes. This would be particularly desirable if no change in attitude towards CCA occurs (and the resulting large overstatement of benefits). This approach would be less likely to cause adverse reactions from other countries.

A final point on profitability is that it is always necessary to rebut the "wag" who suggests that because a project or firm can be profitable an incentive is not needed. Experienced personnel have no difficulty in noting that one must attract profitable ventures away from other more profitable locations. This statement of the obvious is repeated because it is not always obvious to those preoccupied with other matters.

The types of considerations to be studied would include the degree of precision with which the project could be defined, its potential scope including any related phases, etc., the "order" or range of profitability potentially involved, the probability of achievement, the timing for the attainment of profits, the complexity of determining the actual profits, and, of course, the benefits to be derived from the project. As indicated, the inducement decisions would usually be of the locational cost comparisons or threshold type. Scale and timing (or acceleration) types of decisions would only be infrequently supported. (Admittedly it is possible to consider that certain of the major undertakings would have an acceleration element to them, but fundamentally these would tend to be threshold analyses.)

A number of different types of tax allowance incentives can be used, including

(a) higher rates

(b) higher amounts, such as 200% of the normal amount (see appendix II).

While these mechanisms are very useful they have been used extensively within the national system of taxation for the manufacturing industry and accordingly have a very uncertain place in future regional planning. In this regard it is noteable that firms can only use a certain amount of tax credits, depending on their income flows. As well a continuous argument of differential treatment between big firms and small businesses is continuously advanced which causes some unnecessary backlash.

Convenient alternatives are available in the form of grants which could be based on tax allowances which would be normally applicable and which could even be adjusted to offset the different treatment for small businesses. On the other hand, this approach is so close to being an offshoot of the tax system that it does lose some of its value as a sharp instrument and it would probably be preferable to identify these instruments as being worthy of consideration for a residual place on the incentive shelf for manufacturing and processing.

Regarding the service and primary industries, there is more opportunity for the use of tax allowances since these industries have not received tax incentives as often. Also, it is particularly desirable to give careful consideration to the use of profitability incentives for these industrial sectors, if it were concluded that a general program with a degree of automaticity were desirable.

B. (4) Cost-oriented Incentives

Cost-oriented incentives can be particularly advantageous in stimulating entrepreneurial interest in activities where the determination of cost is particularly sensitive. By sharing all or some of the uncertain costs with entrepreneurs the Government can induce greater participation.

In comparison with profitability incentives, cost-oriented incentives have the advantage that it is not necessary to determine the sales or revenue activities of the enterprise. Of course, it is necessary to test the revenue elements in order to ensure the appropriateness of the cost charged - i.e., that the costs charged do relate to the products produced and sold from the project.

The complexity of determining appropriate costs is well recognized, particularly since the Government has had long experience in examining such through organizations such as the Audit Services Bureau, Taxation Division, etc. If a cost incentive were to be authorized for selective use, two different gains are identifiable.

In the first instance, a number of projects could be attracted by the program which would not otherwise be considered for the regions. In the detailed discussions between the applicant and the Department, anticipating the specific problems respecting determination of cost would enable agreement to be reached in most cases as to an acceptable definition of eligible costs allocations or profits.

Secondly, where the discussions revealed that wide variances would preclude reaching an understanding on a realistic approach to cost measurement, alternative forms of incentives would be considered, such as the more conventional

gap-estimated incentive. It would be possible in a number of such cases for agreement to be reached. Thus, even for those projects where the cost-oriented incentive is not attractive or practical, the availability of some form of incentive would result in maintaining the entrepreneur's interest in locating the facility in a designated region.

Thus these instruments can be useful even for those cases where they may prove in the final analysis to be unacceptable.

An elaboration of the problems and alternatives is set out in Section D.

It is appropriate normally to select only a number of elements of costs. Some costs of a fixed nature, such as administration, insurance and overhead depreciation, tend to be less meaningful for inducement consideration under a cost-oriented approach. Generally elements of variable costs of a direct nature can be used as the bases of such incentives. These include: (a) Labour costs including overhead labour; (b) Salaried personnel, where variable; (c) Direct charges, including the leasing and subcontracting; (d) Start up and running-in preproduction costs; (e) Financial cost, including interest, feasibility studies, etc.

A premium on employment could be an acceptable alternative to the present part of the Grant of a percentage on the average labour cost over the second and third years of operation. The premium could be tied to exact figures of wages and salaries for the first three or four years of a project at a rate in the order of 20-30% of these costs. Important features of the alternative are the following:

1. heavier emphasis is placed on employment, particularly as it is actually generated rather than on projected figures

2. it would heighten the visibility and authenticity regarding the identification of jobs created by a project

3. measurability of cost-benefit could be facilitated

4. increased administrative costs would be marginal

For cases of special merit, the deferral of benefits at the outset could be mitigated by an increased incentive on ACC.

Start-up and running-in expenses or preparation costs are suitable cost elements on which financial assistance can be measured. Although accounting treatments vary (as does its effect on tax situations) they are legitimate capital outlays which may run into significant figures. Assistance could be at the same level as that of fixed assets, particularly for projects where local services are less adequate than would be the situation in an alternative location otherwise preferred by the entrepreneur.

A definite improvement in the quality of projects in the small and medium size range would be ensured if these were better planned by means of professionally executed feasibility studies. A suggested level of assistance would be 50% of the authorized cost of an approval study.

As regards leasing, such should be included with more effective administrative procedures. Sub-contracting as a base on which to establish incentives is of little significance due to its impracticality.

It is considered that cost-oriented incentives should be used for high priority objectives with individual decisions being made in each case. In certain instances it may be desirable to cover only some of the sensitive cost factors and to provide the normal Group B type of incentive on the more stable aspects.

Several illustrations are shown on Appendix III.

B. (5) Investment and Reinvestment Credits and Reserves

Reinvestment credits are available within some of the existing incentives under certain conditions. It is particularly desirable to provide bonuses for reinvestment activity and the proposal with respect to grants on profitability includes a specific provision for special inducement. In the event that the proposal on grants on profitability was found not to be acceptable, it would be most desirable to consider specific provision for a reinvestment credit which could take the form of a supplementary percentage based on an earlier investment or on the subsequent investment or alternately on the outflows (profits), etc. from such investments.

It is considered that the principles applicable in the investment reserves system used by Sweden and to a certain extent by Canada previously should be developed more positively for the future.

The Swedish approach includes a regional element, as did the Canadian, but a stronger weighting on the regional element would be desirable. Particularly taking into account the need for a better long term utilization of land resources and a minimization of the concentration of economic activity in urban centres and particularly those in central Canada, it is to be hoped that the additional work would be done on this approach immediately, so that the most effective method of benefiting from the several objectives could be devised for implementation in the very near future. It is possible that the timing is ripe now, although it is probably slightly premature. Therefore, progressive educational work, together with the evolution of the most acceptable system should pay attractive benefits.

B. (6) Equity Participation by Government

It is felt that while there are several considerations in favour of specific involvements of the department in equity roles these are outweighed for general application by the following complications (a) the financial community and public would get a confusing picture of the role of government from such ventures

(b) the government might be regarded as being required to attend board and shareholder meetings of very small firms etc.; large companies would resent any suggestion of government participation in their business.

On the other hand, it is felt that it might be useful to consider having a crown company administer funds for equity participation where desired. These funds would be quite separate from departmentally administered funds and the corporation would be in a more independent position to take decisions and account for its actions. In this regard it is noted that the FBDB is not really intending to take higher risk positions.

The report of the 1973 Task Force of Incentives covers this subject in greater depth and is provided in supplementary papers for this 1976 report.

(7) Venture Capital

It is considered that it would be useful to support the provision of venture capital in the designated regions. RDIA and ADIA were mechanisms with a sub goal of supplying additional capital to designated regions because of shortages available for development.

One means would be to encourage the supply by providing a tax break for firms' funds which were "rolled over" in designated regions by venture capital firms. The problem of distinguishing such capital flows could be handled by firms submitting tax returns identifying the funds invested in Designated Regions. The Revenue Canada form could be vetted by DREE as desired by that department.

B. (8) Special Cost Offset Incentives re Relocation Operations

While the relocation of operations from an existing facility to another facility is generally discouraged because of a number of factors, there are a number of situations where this type of activity should be encouraged in a positive way. Apart from consolidations which are dealt with elsewhere, the most important type of activity is one where there is the alternative of either carrying on the existing operation or reducing it and possibly eliminating it with the transfer to a designated region. In this event, of particular interest is the situation where either a new line of products or an expanded line could be added on to an existing facility or could be established in a designated region where normal economics frequently denote that the new activity be located in or near the existing facility. It is critical to explore vigorously its alternatives whereby the new activity and part of the existing operation could be carried out in a designated region through the provision of an incentive to the new activity and the supply of an inducement to the firm to change over its existing operation, in such a way as to utilize the existing labour force on a different operation. This would then enable both the existing facility and the new activity to be undertaken in the designated region but the provision of adjustment assistance to the firm could overcome the reservations with respect to potential disruption of the labour force, the local community with its existing tax-base, and related suppliers.

This type of approach can be accommodated by a capital cost incentive but there are instances where the cost adjustment approach should be particularly beneficial. As well, a profitability incentive could be more useful in pulling off the more intricate set of undertakings. It is acknowledged that this would not be a frequently used mechanism but is one particular approach, the need for which has been identified in the more selective approach to industrial promotion.

B. (9) Combinations

It is unnecessary at this particular juncture, because of the other references in the report, to dwell on the desirability of providing combinations of incentives.

However, for convenience it is appropriate to indicate that the most important use of combinations would be to accommodate those projects which either

(a) had such a long period to attainment of profitability that an earlier payment is considered appropriate, or

(b) where profitability is potentially high, requiring the implementation of a ceiling, in which case the entrepreneur might request the implementation of a "floor", which would best be related to a capital cost or job type of incentive.

A series of options has been developed and is shown on the Appendix.

C. Advantages and Disadvantages of Alternate Incentives from Various Viewpoints.

This section is discussed in two parts:

(a) main advantages and disadvantages of the more desirable incentives

(b) viewpoints to be taken into account in determining the incentive

(a) The main advantages and disadvantages of the more desirable incentives may be summarized as follows:

1. Profitability Grants

ADVANTAGES are as follows:

(a) Maximum interest is stimulated among entrepreneurs, since the incentive varies according to the amount of profits.

(b) The incentive can provide sustaining growth of employment and investment for the area, if tailored and applied specifically.

(c) Firms participating are encouraged to concentrate particularly on profitable operations.

(d) Activities induced into the areas, being profit-oriented, will have a lasting influence on other firms, etc., in the area and indirectly influence additional activity. Sharing of the tax burdens is beneficial; stability for workforces is good, although some competition for labour may inflate wages and hurt other industries.

DISADVANTAGES:

(a) Incentive cost can be high unless controlled.

(b) Profits can be artificially inflated unless controlled.

(c) Differences of opinion respecting appropriateness of profits can create disharmony with clients.

(d) Criticism of the program can be broached by those who do not understand that profitable ventures merit inducement incentives.

(e) Sensitivity could be aroused in other countries as well as in the "have-provinces" if incentives were, or appeared to be, too generous.

(f) Cash flow is not provided for new firms or non-profitable firms.

2. Tax Credit Based on Profits.

ADVANTAGES

(a) see the benefits of a profitability grant (see // b-c)

(b) the tax credit is easier to administer in the sense that many rules are already available for such type of operation

(c) experienced staff in Revenue Canada are available in large measure to handle the program

(d) the Government does not have to raise cash flow

Disadvantages:

(a) The attitude of Revenue Canada as a Revenue Agency cannot be expected to be as neutral as that of a development agency.

(b) - (f) See profitability grant.

(g) Cash flow is not provided for new firms or non-profitable firms.

Tax Credits Based on Investment Cost

Advantages

(a) Profitable operations can be given preference, by requiring the credit to be used for the subject project.

(b) The incentive can be used to encourage the undertaking of a series of projects.

(c) Flexibility re selectivity is available - the credit can be provided on a discretionary or other basis, as preferred.

(d) The incentives can be allocated for use against profit, costs or revenues of the subject project or other business, as preferred.

(e) Government does not have to raise cash.

Disadvantages

(a) Unequal treatment can result because tax credits may or may not be useable by some firms and if useable may not be fully useable; where fully useable they may have a different impact, varying according to the firm's tax rate. (Some adjustments can be introduced to reduce this - e.g. a double credit could be given for business subject to a 20% tax rate, thus equalising the effective rate.)

(b) A greater understanding of the tax system is required by foreign firms and this can result in reticence on the part of the entrepreneur, misunderstandings and extra costs.

(c) True costs are less understandable for the Public, Parliament, and others.

(d) Some projects could compete with established industry, unnecessarily, unless some specific protection is built in which restricts the use of the credits.

(e) Another department's legislation and staff administration are involved.

(f) The tax "rights" principle can cause some firms to receive the benefit or others to suffer, unless safeguards are built in.

4. COST INCENTIVES:

Advantages:

(a) can be used vigorously to overcome uncertain cost factors

(b) close monitoring of unusual operations can facilitate the administration's knowledge of problems

Disadvantages:

(a) the problems associated with profitability incentives are almost the same, although selling price problems are avoided.

(b) operations may not be profitable in the long run.

(c) Such activity is suspect in the public eye and the program can suffer through adverse publicity.

(b) Viewpoints To Be Taken Into Account:

The aforementioned advantages and disadvantages must be weighed from a number of different viewpoints.

It is easy to over-simplify the advantages and disadvantages of various incentives and thereby run the dangers of not maximizing the effectiveness of the incentives program. There are many different viewpoints to be taken into account in determining the more suitable incentives including those of the following interested parties: entrepreneurs, shareholders, managers, financiers, suppliers, government administrators, Parliament, and the many publics. Included in the latter is (are) the community(ies) considered for a venture, competing communities outside the area

considered for a venture, competing communities outside the area including those in foreign countries, other supplier and user groups with an interest in the locational decisions and others who make economic contributions or whose interests are indirectly affected in ensuing activities, discussions, debates, etc.

Without specifying the viewpoints of each of the aforementioned parties because of space constraints, it is possible to highlight a number of the more important considerations. Entrepreneurial interests take two main shapes, particularly that of increasing the entrepreneur's sphere of interest and the maximization of profits and minimization of risk. Included in both of these aspects is the potential that a single venture may lead to other ventures and related multiplier effects.

Single and small-member proprietorships have a number of widely varying aspects which need only be alluded to here, with one of the more important features being the higher emphasis on sphere of interest frequently because of personal or family involvements.

Shareholders are primarily concerned with profits and their interest ranges (a) between maximizing and balancing profits and (b) between minimizing and balancing risks.

Management tends to concentrate on performance objectives which will obtain recognition for achievement in a number of different forms, but particularly those relating to the maximizing of their bonuses and personal accomplishment (promotions, prestige, etc.)

Financiers tend to follow the maximization principles. This varies for organizations like banks which are large enough to have to take into account greater community and other public interests necessary in the attainment of overall performance objectives (as contrasted with decisions on individual projects). Suppliers of materials, energy, etc. have to consider the long and short term market considerations and of course the balancing of risks with aspirations for their own growth, or indeed, in certain instances, their survival.

It is perhaps sufficient to merely allude to some of the absolute contrasts concerning other interested parties. Some wish change to be rapid, others wish such change to be slow and conducive to progressive adjustment. Some wish activities to be influenced marginally while others wish strong interventions; some seek performance and cost measurement while others, of necessity, wish a more obscure accounting and accountability, etc.

Turning to the significance of some of these aspirations and interests in relation to the subject incentives, profitability incentives have the potential to provide aggressive, positive action which can give a strong thrust in the direction of structural economic change. At the same time such incentives have the potential for higher casualties, 'slippery' activities, and, perhaps, most importantly they produce the extreme danger of possibly precipitating disruptive retaliation, imprudent bidding and, indeed economic warfare between communities, provinces and countries.

The straight "no holds barred" approach would focus interest in the program in a very positive way. This high level of interest should generate more meaningful projects with a potential to influence the industrial structure of the regions. The cost of course in terms of dollars must be much higher and the public concern would probably emphasize the need to have, normally, certain ceilings on the incentives provided.

This urge for limitations would of course reduce the zeal with which enterprise would otherwise examine opportunities for industrial location in the designated regions. If, however, suitable emphasis could be placed on obtaining more moderation in profit attainment and risk-taking this could still provide a program shift which would still be sufficiently exciting to the private sector - as long as the potential for a maximum incentive were available "on the shelf". In other words, where the incentives could be extremely elastic, limitations and floors would be put on the projects selected, but in the case of key industries if a careful appraisal of all of the economic, social and potential circumstances indicated the acceptability of a bolder course of action then the fuller more dynamic incentives could be utilized.

This approach has potential for the future and indeed has been previously used in Canada in a simpler fashion. The 1963 tax incentives were strong profitability incentives which played a meaningful role in stimulating the interest of major companies and getting a quick and meaningful regional intervention. These temporary incentives (the Government instructed that alternatives be examined for early consideration as soon as experience was gained) evolved into a more gradual transitional type of incentive in 1965. The latter has resulted in what may be described, in the main, as a more acceptable if somewhat slow adjustment process. Today, the limitations of profitability incentives can and must be weighed again because of their potential strengths for more useful structural change.

Naturally, in view of group B's mandate, only a limited word is necessary respecting the more traditional incentive grant. While some of the comments in this paper relate to the more defensive version of the instrument it is still important to consider profitability incentives in comparison with a more vigorous "gap" and inducement grant incentive i.e. one which is paid out earlier and possibly with more risk-taking, such as a guarantee of performance rather than a holdback.

In this light the profitability incentives have less of an advantage since the "gap" grant is less uncertain than profits in the future. On the other hand the benefit is "fixed" and the profitability excitement more limited. In addition, the type of guarantee which might be acceptable and the type of firm to whom advance payments might be made more readily would be open to "big firmitis."

Thus there are pros and cons which favour the use of both types of instruments with judicious discretion respecting major policy objectives and the problems inherent in such interventions. On balance there appears to be value in having both instruments and indeed in "mixing" both in order to get a blend of strong inducements and positive if less vigorous, but more "comfortable" interventions from the viewpoint of the international community.

In a lower key it is also worthwhile to speak of the progressive development of other industrial sectors than manufacturing through the use of profitability and investment incentives as a defensive filter for good projects.

The use of cost-oriented incentives can be of value in encouraging the undertaking of activities whose viability is dependent on 'other things' happening and in this way government and the entrepreneurs can share the risk - and the benefits.

D. PARTICULAR PROBLEMS ASSOCIATED WITH DETERMINATION OF PROFITS OR COSTS FOR A PROFITABILITY OR COST GRANT (OR TAX CREDIT)

Obviously, one of the most difficult matters associated with profitability incentives is the determination of what are reasonable profits. Just as in any allocation of costs or revenues in any organization, even the most fair minded or dispassionate approach to this subject never results in what could be regarded as an accurate answer. Accordingly, when significant funds are at stake, the managers and entrepreneurs of the firms, the administrators of the program, the evaluators of the program, the competitors and anyone else interested, always have to have concern and indeed alarm as to whether or not the costs, revenues, incomes and profits have been either accurate or reasonably allocated. This is elemental.

It follows that a profitability incentive, if it is to have strength in it, must be designed and administered with the greatest of care. These problems are not insoluble in a number of cases. Where they are insoluble, one simply does not offer the incentive.

Several considerations mitigate the problems. First, there are many activities which have been the subject of cost and price analyses. The Audit Services Bureau and Revenue Canada officers, together with others, have had long experience in these fields. Accordingly, a body of standards can be developed for consideration in negotiations with firms. The type of firm and its activity present a range of different problems. These can be suggested by the following classifications:

(a) Firms establishing a first facility in Canada.

(b) Firms establishing a different type of facility from any which they already have in Canada.

(c) The establishment of facilities which are very different from other activities already established by the firm.

(d) Firms with substantial sale of components to arm's-length purchasers.

(e) Firms which have a great deal of common components supplied to different branch establishments but not to arms-length firms.

Clearly, in the first instance, which appears reasonable simply on the surface, there can still be problems of non arms-length transactions with offshore suppliers or purchasers. Examination of the specifics of the type of activity can result in an appreciation of whether or not the problems are capable of control. Ways and means of reducing difficulties are to establish standard costs, use cost and pricing indices, or other control devices. One of the alleviating considerations is the fact that the firm may stand to gain only marginally from profits taken in Canada rather than in the foreign country.

Where firms are Canadian-oriented and have bases of costs and prices already established, it is possible to reach agreement on standards and adjustments for determining basic prices.

Clearly, where the detailed negotiation presents problems, which appear to be too formidable for resolution, both parties may be more inclined to consider other alternatives if the opportunity under consideration has reached a stage where the firm is seriously interested in proceeding. In this set of circumstances, it is quite possible that the firm and government could reach agreement on another alternative which would involve an entirely different type of incentive or a mixture of a different incentive and a profitability incentive with less pressure on the profit consideration. The latter would minimize the greater dangers of unfair agreement and a bad experience between the entrepreneur and the government down through the years.

It is necessary to emphasize that the profitability incentive is a very favourable marketing tool and should not be used for bait and shift. Accordingly, if such an incentive were used it may be made clear that it is a very select incentive and only applicable for the most important type of venture, and where terms and conditions can be established which would be suitable for both parties.

One of the most attractive features of the profitability incentive is its potential asset and "open-ended" stimulant which permits future activities of forms to be considered well in

advance of their firming up as as a specific proposal.

These types of progressive developments are one of the most meaningful elements in an industrial development strategy and if it is possible to reach agreement on the set of terms and conditions which would be susceptible of accommodation, then the use of the incentive can be very significant. By the same token, the very openness of the arrangement presents more problems of control. It is essential to recognize these difficulties and to be alert to the need to avoid extreme optimism in designing such an incentive. Nevertheless, because of the utility of this approach, it is vital to develop a set of arrangements which could be applied for the right type of activities. A particular alternative is the use of a reduced profit factor through the mechanism of ceilings. This would keep the pressure on the firm to generate activity while at the same time reducing the dangers of extreme profit positions.

E. Desirable Weights of Incentives

The desirable weight of incentives, of course, is the amount which will cause the entrepreneur to do that which he or she would not normally do, where such an incentive is reasonable, bearing in mind the economic and social impact being generated. At the same time, it is perhaps appropriate to note in passing that a desirable minimum weight in the mind of an entrepreneur may be inadequate if a serious miscalculation has been made. (In such an instance, the Department does have an interest in giving consideration to a more appropriate level of inducement).

In the view of the entrepreneur, a number of factors include the following:

(a) The expected return on equity and investment, or

(b) The likely level of risk or the probability of achieving the profit levels

(c) The market share attainable

(d) The profile of the firm which may be achieved and its influence on other sales and on Government

(e) The PR image of the firm for its general consumer orientation and its visibility in the communities in which it is established or hopes to establish

Needless to say, a number of other considerations come into play, particularly where the existing entrepreneurs have unique interests. In certain cases the owners may well be satisfied with the obtaining of a lower than normal rate of return because they are generally content with the carrying out of the business for purposes of self-gratification. Naturally, this gives rise to a question of the longevity of the operation and the appropriateness of supporting it, and to what extent. In the case of co-operatives, the traditional outlook must be modified frequently.

The most basic consideration is the set of alternatives available to the entrepreneurs. In addition to the classical alternatives a particular consideration will be what competitive countries etc, are paying by way of inducement to attract such ventures.

Note: It is assumed that the reader is aware of the relative role of the basic factors determining industrial location and incentives.

Turning to the Department's position, this is governed principally by the objectives identified at the outset. The provision of long-term employment is a basic, but in certain instances it is necessary to "buy time" and quite a different perspective may be taken. However, in general the Department's view is obtained from a fairly broad base which measures the benefits which are achievable in relation to the cost.

Accordingly while it is impossible to identify in a broad sense specific levels of incentives which will be required, it is possible to identify the order of incentive which can be expected to be required under a broad set of circumstances.

Incentives on new industries which provide the appropriate return and inducement can be expected to fall into the range of 40% to 50% ACC for a normal mix of factor inputs, assets, etc., in view of the need of the entrepreneur to establish a completely new operation, management, distribution system, etc.

Variations include activities where the capital employed and the labour intensity (in a viable industry) may make it desirable to go above this level. Where industries are significantly important the order of incentive can be expected to move up beyond these magnitudes in order to provide benefits of over 5% of operating costs per annum. Conversely, where a project has a unique opportunity to be profitable, a lower incentive would be appropriate at the level required to beat the competition provided by an alternate site.

The inducement of volume expansions can be expected to fall into the order of 25% of ACC. Naturally, some volume expansions which involve new technology on a tremendously different scale and the establishment of new markets will draw the same order of incentive as a new industry to an area.

Modernizations can normally be expected to require an incentive in the order of 15% to 20%* of the approved capital cost.

The aforementioned "orders" of incentive relate to manufacturing and processing activities on which there is considerable experience and to the regions which have a reasonable range of opportunities insofar as lagging regions are concerned.

* real values; not with loss of CCA privileges.

Respecting other considerations, manufacturing and processing industries differ significantly, as evidenced by Appendix V.

The order of incentive for tertiary and resource type of activity is beyond the scope of this report. Suffice it to say, however, that the order of incentive would be determined on the same very broad principles and that the cost-benefit relationship used for manufacturing and processing would have to be taken into account so that the best competitive approach was utilized. The exception to this would be where it was desirable for higher policy purposes to establish a breakthrough in new industries being identified for priority treatment.

With respect to extremely remote and isolated areas without adequate infrastructure, questions as to the desirability of developing or maintaining such areas become particularly important. Also, areas in close proximity to growth centres are where widely different views can be taken. On the one hand, it may be possible to induce the industry more economically because of the prospects of other industry coming in, and thereby providing a better supplier base for the subject project. Conversely, it may be particularly important to get the lead off industry for a series of projects being sought and in such an instance a higher than normal incentive would, of course, be appropriate for consideration.

It is considered that the incentives identified are capable of achieving the different weights. On the other hand, it is repeated that it is not desirable to utilize the profitability incentive (other than capital cost allowances) for light incentives.

In summary, having regard to the principal objective for which P.C.R. incentives should be aimed, it is to be expected that a weight which provides benefits of over 5% of operating costs per annum will be necessary for significant new industries to regions.

F. Features of Preferred Incentives

1. The main features proposed are tailoring, flexibility, selectivity, neutrality (in the sense of isolating cost and income elements) and accountability.

2. Selective - the incentives must be tailorable to the particular project under consideration. Preferably the department should be able to select one or two incentives, for which the entrepreneurs may be invited to express a preference, thereby enabling the most reasonable agreement to be reached.

3. Large-impact orientation - because of the high manpower implications the incentives should be concentrated on cases with larger impacts. An exception would involve a supplementary or general benefit such as CC allowances or investment reserves.

4. Multi-phase projects must be accommodatable for effective and efficient use.

5. Neutrality of measurability is critical and therefore administration should preferably be in one organization which is sensitive to the various viewpoints of the areas, the public, and the business enterprises.

6. The incentives should be broad and flexible in their character so that they can be applied effectively which must involve a number of changes over the next decade. Accordingly, the legislation should cover only the major principles such as the DREE Act does and control should be exercised on the department by Parliament for high policy and by the Cabinet for important issues.

7. The incentives should be able to be adjusted to many different mixes of activity and industrial approaches to carry out such.

(8) Profitability grants should take into account the aforementioned general features. The length of year-span over which the grant should be based should run in the order of 8 years. This length gives entrepreneurs an adequate time frame within which to make adjustments and overcome unforseen problems during the first year or two of a project - and still have sufficient time to develop a strong enough profit position to obtain reasonable benefits. On the other hand, this time period provides the Government with a viable operation, not only in view of the foregoing but as well because the firm has an inducement to bring into the operation any additional activities on which it can anticipate a profit. Of course, it is up to the Government to build in sufficient safeguards so that the added activities do not generate unfair competition to existing establishments and provide excessive profit to the applicant (in relation to benefits obtained).

In certain instances, it will be desirable to build in a time option whereby the firm which does not encounter certain problems but does achieve certain levels of profitability receives a reduced rate of benefit in succeeding years. Here it is necessary to devise a commitment for carrying on of the activity beyond the shorter period, if such appears desirable. Normally, it won't be necessary.

Additional phases can draw a supplementary benefit period of perhaps several years or alternately a bonus based on fixed costs. See the discussion on multi-phasing.

(9) Regarding a cost-oriented incentive, the time period should normally run in the order of four years in order that the project does not take on the appearance of a continuing subsidy. In certain instances, it will be desirable to have the rate period "float" depending on performance achievement. This approach could accommodate additional phases which would be added into the venture.

(10) Capital Cost Allowances should be provided in three ways

(a) Normally the allowances should be claimable only on the subject venture. This ensures that profitability operations only are stimulated.

(b) Where it is desired to be less defensive, the aforementioned principle can be relaxed and it can be useful and the allowances can have a rider attached that, if the subject project does not achieve profitability status sufficiently early to use the special capital cost allowances, then such allowances may be claimed against other profitable ventures of the subject firm. This mechanism would provide greater impetus to profitable firms who would be able to withstand adverse performance in the first few years of a project and still be able to produce the long term viability which would

generate the continuing jobs required from the program

(c) When a very aggressive approach is desired the special capital cost allowances could be chargeable against any profits of the firm. This would provide the greatest degree of encouragement for strong entrepreneurs and would give the region the best opportunity from this type of incentive. (Of course, it would not compare with a heavier type of incentive).

(11) Respecting Canadian investment credits, the same principles apply for re-investment credits as are enunciated for special capital cost allowance rates, except that they are related to re-investment ventures.

G. Evaluation of Importance of Preferred Incentives.

The incentive with the greatest potential is the profitability grant because of its high emphasis on profits and viability and its flexibility. The elasticity of the incentive gives it a major role to play: it can be varied in many different ways while still maintaining an important profit-generating function; it can be used with a floor and a ceiling or without either; it can be used in concert with other incentives especially where one incentive provides a minimum level of exposure and the other stimulates the aggressiveness required for competitive industry.

The main weakness of this incentive is its profitability orientation - but this can be accommodated either by combining it with a capital payment or a cost incentive. Alternately, a cost incentive can be used.

The tax credit has a potential which ranks very favourably but nevertheless below the grant because it has a heavy two-department involvement, although it tends to be more "cut and dried" in appearance. It has the same weakness as the profitability grant.

Cost-oriented incentives can be of particular value. These may rank immediately after the tax credit and probably before it if the latter is bypassed for a profitability grant. they can be very directive and can bridge the period when profits are not achievable and as such they fulfil the need to share the problems of the build-up period.

The investment reserves have some considerable potential in the long run. Whether this can be implemented in the next several years and whether the national and other aspects will outweigh regional interests is a very uncertain matter. In view of these factors it is probably logical to conclude that the reserves approach and the tax allowances are equally beneficial since the latter have an uncertain value to them because of the wide and frequent use of them for the manufacturing industry.

Both are probably advantageous for use in the primary and service sectors. Their level of impact is in the order of 10-20%, although it is possible to increase the potential for each to that of a major incentive equal to 40% to 50% of capital cost. However, this seems a questionable way to use the instrument, principally because it may be used as heavily for other purposes, thereby negating the regional advantage.

H. Impact

It is extremely difficult at this time to anticipate the order of economic impact and of resource utilization associated with the preferred profitability incentives. This difficulty is compounded by the need to meld the work of the 4 incentives working groups. Further, it is very difficult at this stage to forecast the magnitude of GDA impacts and when they will occur.

However, it is essential that some estimates be made for scoping purposes and in particular to enable a better appreciation to be formed of the proposals therein.

Assuming that the profitability incentives were used very selectively on major projects, it is conceivable that as much as 25% of the significant economic impact could be covered off by this type of incentive from time to time. However, it is more probable that the magnitude should be something more in the order of 15% to 20% of the incentives programs' impact. In the initial years the impact level might be lower until confidence in the approach was evolved. Accordingly, it is estimated that in the order of 10% to 15% might be initially achieved moving up to a share of between 15% and 20%.

It is perhaps unnecessary to suggest that if the policy emphasis of incentives programs were to move markedly toward existing entrepreneurs rather than new industries etc., these shares would be heavily affected - probably halved.

Assuming the before-going activity level and presuming that the current level of one hundred million dollars was sustained, it is possible to speculate on the number of jobs which might be directly created. Since it is proposed that the incentive be used for very directive activities, it may be prudent to use a cost per direct job in the order of fifteen to twenty thousand dollars. This would give an impact of eleven hundred jobs per year, with commitments at this level starting two years after introduction of the program.

x contain

Thus, the possible level of activity influenced might run around six hundred jobs in year 0 plus 2 rising to 1,100 in year 0 plus 4.

The foregoing relates particularly to manufacturing and processing. In the event that it were desired to use the incentives as a broad tool to influence the primary and tertiary sectors this would have to be taken into account. If these sectors were to compete for the aforementioned budget then the previous figures could stand. On the other hand, it is considered appropriate to include an incremental amount for the addition of these sectors. In the initial years one could assume that the activity buildup would be low, unless it were desired for policy reasons to create an early impact. In this latter situation it would be necessary to use a heavy hitting incentive, such as tax holidays and the cost could be commensurately high. At this stage it is not intended to speculate on the magnitude involved.

Other resource considerations involve an increase in operating expenditures. It is assumed that performance evaluation would require at least triple the time now required to examine a complex and difficult case. Accordingly, it is assumed that manpower requirements would increase three fold for the 15% of the manyears spent on large projects. Thus if 15 manyears out of a hundred is today spent on large cases and if one half of this work done were devoted to profitability incentives the increase for such incentives would be in the order of 10%.

On balance, in order to get more impact in a directive way, it is considered that the increase could be reasonable.

Note: These costs are overstated somewhat, assuming the employment of junior staff on some of the more routine work.

I. Industrial Sectors Emphasis

Given the special purposes identified and the order of cost suggested for profitability incentives it is logical to conclude that the probability incentive would be used to the extent possible to induce priority industries to establish or expand in appropriate areas in order to modify and strengthen their industrial structures.

Accordingly, those new industries which have the best chance against international competition would draw particular attention from profitability incentives as long as they are not so "natural" as to have a comparative advantage rendering such inducement unnecessary.

The identification of these industries by region and priority area should receive promotional, development and inducement support. However, projects proposed by private enterprise which don't happen to be specifically classified as structurally desirable but which present attractive opportunities should be considered for special treatment since no directive system can be all-encompassing by its very nature.

Particular industries which need consolidation and rationalization in an area might also be considered for special treatment but this is more satisfactorily caught by other approaches. However, cost-offset incentives should be useful in rationalizing the regional sharing of certain industries.

Turning to the need to expand the eligibility sectors, little needs to be said about the diminishing share of the manufacturing industry in the face of the tertiary industry's growth. Progress in this field must be carefully made however.

Service Industries

(a) In general these are population chasers and do not need incentives.

(b) The service industries are the fastest growing sector reflecting a shift in the make-up of our society. As such there are opportunities for influencing such activity:

(1) Governments' staffs
(2) Business services
(3) Services presently classified as manufacturing and processing or primary industries.
(4) Tourism and recreation.

(c) In particular the statistical and other specialized processing offices of Government, business and industries can be examined for location in designated regions. The current status of communications facilitates this specialized location at a more reasonable cost.

(d) It was recognized that some of the activities might be susceptible to general stimulation and in view of the precarious nature of some of the activities such as tourism it was considered that profitability-oriented incentives can be particularly worthwhile.
Allowances for new offices could be particularly utilized in order to reinforce the support of profitable operations.

It would be possible to modify the forgoing by permitting write-off of allowances against profits of other activities of an enterprise if the new activity turns out as unsuccessful. This would be a means of guaranteeing a minimum level of support but would tend to restrict activity to firms with good financial resources which would stand them in good stead in the face of adversity.

(e) Transportation and communication merit particular emphasis.

Primary Industries

(a) Many resource industries have to be located at the resource site. Threfore the resource industry is not as "footloose" as some manufacturing industries tend to be and it is not as susceptible to financing or scale inducement. Exercising an influence on one location over another is possible and if the market is satisfied by only one location, a locational choice has in effect taken place rather than merely an acceleration of activity. Any indirect activities are locationally affected. Therefore there is an opportunity to influence location as well as the timing and scale of resource industries, but there will be concern as to the best means of influencing such.

(b) National policy support exists for many resource industries.

(c) Regional incentives can be useful in bringing about the regional location of resource exploitation. They should take into account the national policy support.

(d) Subsidies are very large from some of the industries such as the fish processing program which is now in the order of several hundred million dollars - more than the total RDIA budget. Our caution should not be too inhibited.

As a result of the foregoing it was concluded that the need to exploit opportunities in the tertiary and primary sectors must be pursued vigorously but the role of profitability incentives, per se, is not as clear for many service industries. The use of a labour premium would appear to be particularly useful in this connection since much of the industry is labour intensive. Relocation of special offices of insurance companies etc. could be facilitated with special cost offset incentives.

In summary, because the 'profitability' incentives are particularly related to policy objectives, the identification and encouragement of priority industrial sectors for priority areas merits substantial emphasis. In this the need for the correlation of various regions overlapping aspirations calls for the instruments to be used with care and skill.

I. Regional

Each region has its own distinctive needs and opportunities to be taken into account and in most regions a number of subregional characteristics may also be identified for consideration. Provision for such variations is naturally a prerequisite for any program of importance. Accordingly, it follows that the incentives shelf should include the type which can be used in the different regions at different times with the Federal Government in a position to employ the tools in a manner which will be meaningful within the federal mandate, particularly if special difficulties arise which prevent provincial action. With 10 provinces it only stands to reason that residual capability must be available to the Federal Government. The profitability incentive can be particularly useful in this regard.

K. Implementation

Implementation has a number of different aspects which need consideration.

Legislative requirements would involve an amendment to either the RDIA or DREE Act, to authorize the grant proposals while it would be necessary to obtain an amendment to the Income Tax Act or regulations for tax incentives. If a tax exemption were required, legislation would be needed, while regulations would require amendment for changes in capital cost allowances. Some time constraints could be encountered since amendments to Income Tax Programs must be introduced with budgets.

It is recommended that the legislation be formulated in such a way as to provide the greatest flexibility appropriate and a longevity which is more appropriate to economic adjustment.

The flexibility should permit the addition of eligible industries by regulation, thereby enabling the addition of certain primary and tertiary industries, if and as considered appropriate. Similarly, by using broad wording in the legislation, different types of incentives could be provided but added or withdrawn by regulation - thus providing Canada with a program which can be modified to fit changing international conditions, e.g. to meet competitive incentives introduced by other countries. Parliamentary control over these commitments can be exercised in a responsible fashion through Appropriation Acts.

It would be preferable to have open-ended legislation without a terminal time, thereby permitting longer term commitments to be made - even legislation which had a 10 year effective period would lose 1 year's potential as each year passes.

The introduction of a grant mechanism based on profitability could require an extensive codification of the principles for determining profits. Some current staff will need to retool or update their capabilities and a few additional personnel experienced in cost and income allocations will be required. As well, it will be necessary for the incentive officers to obtain input from industry officers on special aspects of a particular industry.

In the event that grants were based on the amount of tax credit which would be received, it would be necessary to develop additional knowledge on Revenue Canada's tax system.

One of the long standing questions relates to the treatment of capital cost allowances on grants which are related to investment decisions. It could be possible to introduce an accounting mechanism whereby the Department paid an Incentive to the firm based on the assumption that no deduction was made from capital cost incentives and made directly to National Revenue a payment designed to relieve the applicant from any loss of capital cost allowance privileges. This approach would result in showing a "truer" incentive and would still maintain the principles on which the national system of taxation are based.

In view of the importance of establishing rules which will be suitable for the determination of costs, revenues and profits, it would be very desirable to consider the establishment of a small development group. The group could produce an effective set of papers outlining the problems to be anticipated and the ways and means of neutralizing or overcoming such.

It might well be desirable to have members of such a development group actually form a "Flying Task Force" for the handling of early applications involving such profitability and cost incentives applications. In this way, normal provincial staffs would be able to handle the preliminary discussions but could feel free to call upon the special officers until such times as appropriate recruiting and other staff re-arrangements could be made to carry the work load over the longer term.

Consideration could be given to having some of the detailed profit or cost determination work carried out by junior officers under the supervision of more senior officers. In this way some of the higher costs of the work could be offset. It is quite possible that such junior officers would be more amenable to being a floating resource which could be moved to meet the demand for such services as they arose.

APPENDIX I

Typical Grant or Tax Credit Options

A series of typical grants based solely on profits can have a number of different bases such as book profit before tax, book profit before tax and depreciation, profit after tax etc. The examples herein relate to book profit before tax (in application would depend on the agreed rules, thereby becoming adjusted book profit for purposes of R.D.I.P.)

A grant could also be given as a percentage of tax liability. This would be essentially the same as a tax credit based on a percentage of liability for taxes.

The illustrations herein are interchangeable as a Grant on Percent of Profit before tax or a tax credit (or grant equal thereto) against tax liability. Where only one base is shown a simple conversion can be effected by multiplying the tax credit (TC) by the applicable tax rate (.40 for manufacturing, .46 for other industries) or by dividing the grant by the tax rate (.40 for manufacturing etc.)

Thus 30% TC = 30% Tax Liability x .4

= 12% profit before Tax

G of 12% PbT = $\frac{12\% \text{ PbT}}{.4}$

= 30% TC on tax liability

The tables and charts have been developed to show a series of mixes of profitability, sales, capital intensities with incentive mixes which would yield benefits in the order of 30% and 50% of capital cost and a variety of incentive values per job.

It would be desirable to show a series of other mixes such as value added, energy intensity, transportation, etc. but this is beyond the scope of this report.

The tax credit or grant used in these illustrations involves a period of 8 years from start of production.

Table 1 shows a series of mixes of capital intensities (ranging from $5,000 capital costs per employee to $175,000) together with a combination of grants (or TC) which would provid provide a level of incentive equal to 30% and 50% of capital costs. Benefit per direct job is also shown.
Benefit per direct job is also shown.
The combinations have been selected bearing in mind the desirability of the principles of a sharing of the profits between government and business.

Table 2 shows a series of performance mixes (profits to sales; sales to capital costs; capital intensity) together with a combination of grants producing a level of incentive equal to 30% C.C.

Table 3 shows a series of mixtures of profitability (profit to sales) and sales (sales to capital cost) in terms of a tax credit (or grant) as a percentage of tax liability with the incentive shown as a percentage of C.C.

Table 4 shows a series of capital intensities with the alternate levels of ACC, direct job cost and with high job multipliers useable in unusual cases.

Chart - shows incentive rates in terms of capital costs for variations in profitability and sales related to capital cost.

NOTES RESPECTING TABLES

* Capital intensity is main variant and is specified. Capital intensity as measured by investment (in buildings and machinery) divided by the number of direct employees. In the first illustration C.I. of $30,000 means $30,000 capital cost in structures and machinery was invested per employee.

** ACC refers to approved capital costs. For simplicity, calculations assume grant receives full capital cost allowance privileges. Otherwise, adjustments are necessary.

*** 30% TC is a Tax Credit equal to 30% of Tax otherwise payable. G of 12% of Profits is a grant of 12% of Profits before tax.

**** S:C represents the ratio of sales of products to capital cost of fixed assets.

Table 1

Typical Grant or Tax Credit Options

1. Normal Cap. Intensity ($30,000)*

(a) 20% ACC = 20% ACC**

30% TC or G*** of 12% Profits = 10% ACC / 30% " or $900,000 or $ 9,000 pdj

(b) 30% ACC = 30% ACC

62% TC or G of 25% of Profits = 20% ACC / 50% " or $1,500,000 or $ 15,000 pdj

2. Mod. Cap. Int. ($60,000)*

(a) 20% ACC = 20% ACC

16% TC or G of 6.4% Profits = 10% ACC / 30% " or $900,000 or $ 18,000 pdj

(b) 30% ACC = 30% ACC

62.5% TC or G of 25% of Profits = 20% ACC / 50% " or $1,500,000 or $ 30,000 pdj

3. Very Cap. Int. ($175,000)*

20% ACC = 20% ACC

33% TC or G of 13% of Profits = 10% ACC / 30% " or $900,000 or $ 75,000 pdj

37,500 pdj @ M

4. Very Light Cap. Int. ($ 5,000)*

Common 10% ACC **** = 10 % ACC

plus

(a) 10% TC @ S:C 4:1 = 20 30% ACC or $900,000 or $1,500 pdj

(b) 7% " " 6:1 = " " " "

(c) 5.2% " " 8:1 = " " " "

Note: In No. 1 (a) a grant of 20% ACC plus a 30% tax credit would yield 30% of ACC. Alternately, a grant of 20% ACC plus a grant of 12% of profits would yield 30% of ACC.

In No. 4 (a) a grant of 10% ACC plus 20% tax credit over eight years would provide an incentive equal to 30% ACC.

Table 2

To illustrate a low type of profitability incentive.

For a firm with projects with the following possibilities of performance mixes, an order of incentive of about $30,000 is generated by the following formulae.

a. Raw material oriented firm

Very Capital Intensive	High P/S (30%)	Low S/C. (0.6 & 0.7)	(1)	20%	ACC	=	20% ACC
				33%	TC	=	10% ACC
							30% ACC
			(2)	52%	TC	=	30% C.C.
			(3)	20%	ACC	=	20% ACC
				16%	TC	=	10% ACC
							30% ACC

b. Market oriented firm

Moderate to Light Capital Intensive	Mod. High P/S (17.5%)	Mod. High S/C (2.1)	(4)	15%	ACC	=	15% ACC
				25%	TC	=	15% ACC
							30% ACC

c. Other mixes

Very Light Capital Intensive	High P/S (30%)	Very High S/C, (4.1)	(5)	16.5%	TC	=	33% ACC
			(6)	10%	ACC	=	10% ACC
				12.5%	TC	=	23% ACC
							33% ACC
		6.1	(7)	12%	TC	=	33% ACC
			(8)	10%	ACC	=	10% ACC
				8%	TC	=	23% ACC
							33% ACC
		8.1	(9)	8%	TC	=	33% ACC
			(10)	10%	ACC	=	10% ACC
				6%	TC	=	23% ACC
							33% ACC

Table 3a

Illustrating a range of formulae for a Normal Mix of $\frac{CC}{E}$ and Variable Profit Levels and Sales: CC

VARIABLES		INCENTIVE IN TERMS OF ACC			
P:S Profitability	Sales CC	33% TP*	50% TP	66% TP	100% TP
10% S	2:1	11% ACC	16%	22% **	32%
	3:1	16.5	24	33	48
15% S	2:1	16.5	24	35	48
	3:1	24	36	49.5	72
20%	2:1	22%	32%	44	64
	3:1	33	48	66	96
25%	2:1	27.5	40	55	80
	3:1	41.2	60	82	120

* Tax payable

** A slight oversimplification throws out other ratios. The correct figures are: 10.8 16.2 21.5 and 32.4 respectively.

Table 3b

Incentives Varying According to Profit Levels and Sales
(Incentive is expressed as a percent of capital cost)

Profit/Sales	Sales/C.C.	Per Cost of Tax Liability 10%	16%	25%	33%	50%	66%	100%
30 %	2				33	48	66	96
	3				49.5	72	99	144
	4	19	33	48	66	96	132	192
	6	29	49.5	72	99	144	198	288
	8	38	66	96	132	192	264	384
40 %	2				44	64	88	128
	3				66	96	132	192
10	0.5				2.75	4	5.5	8
24					5.5	8	11	16
30					8.2	12	16.5	24
40					11	16	22	32
10	1				5.5	8	11	16
20					11	16	22	32
30					16.5	24	33	48
40					22	32	44	64
5	3				8.2	12	16.5	24
	4				11	16	22	32
10	4				22	32	44	64
	5				27.5	40	55	80

Table 4

Options: Very Capital Intensive

Cap. Intens. of $175,000

1. 30% ACC = $900,000 or $75,000 pdj* (w/o indirect)
2. 30% ACC = $900,000 or $37,500 pTj** (with 2.0 mult.)***
3. 25% ACC = $750,000 or $61,500 pdj (w/o indirect)
4. 25% ACC = $750,000 or $30,750 pTj (with 2.0 mult.)

Very Light Cap. Intensity

Cap. Intens. of $5,000

1.	20% ACC =	$600,000 or	$1,000 pdj
2.	30% ACC =	900,000	1,500
3.	40% " =	1,200,000	2,000
4.	60% " =	1,800,000	3,000
5.	80% " =	2,400,000	4,000
6.	100% " =	3,000,000	5,000

Options: Moderately Cap. Intens.

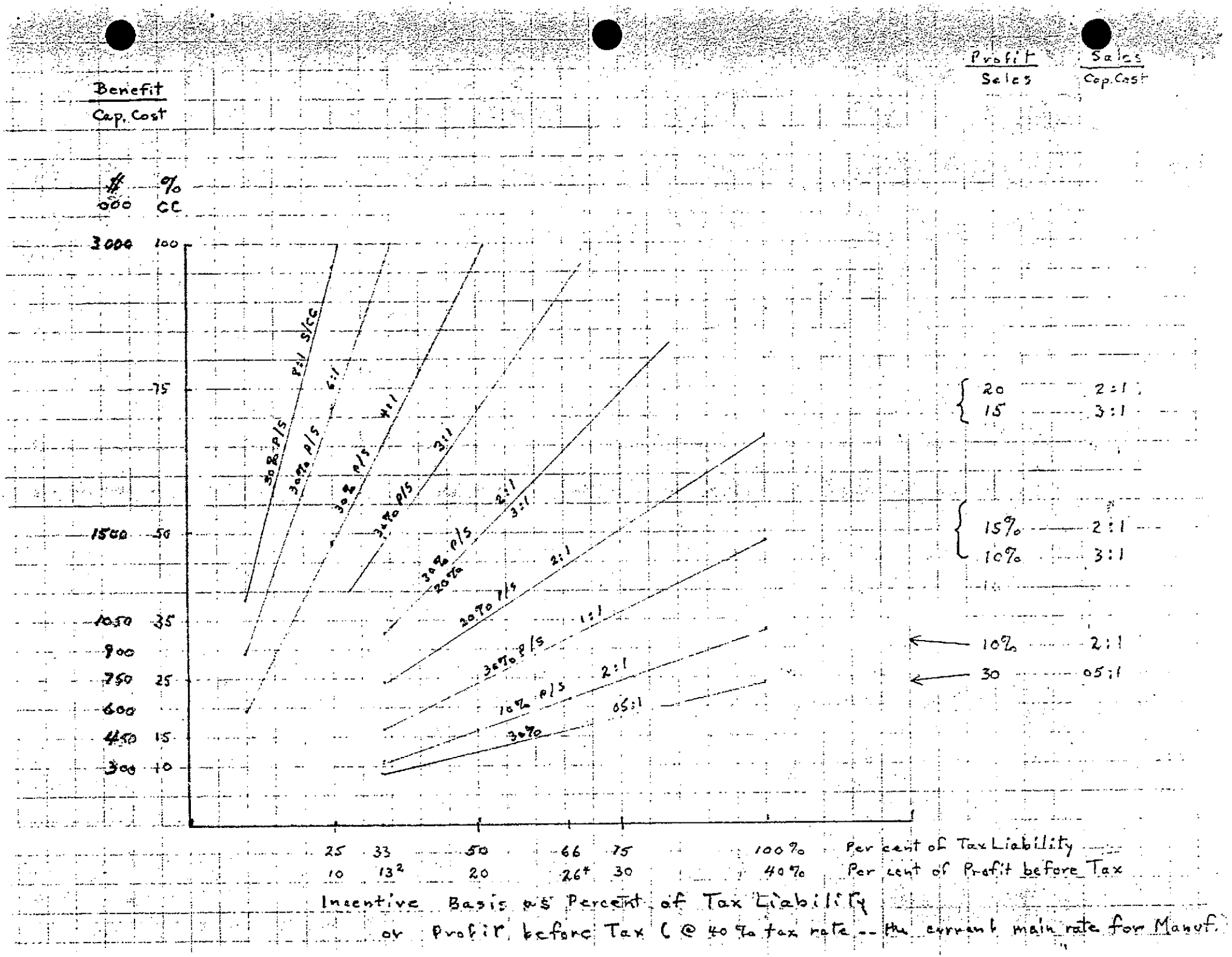
Cap. Int. of $60,000

1.	30% ACC = $	900,000 or	$18,000 pdj (w/o indirect)
2.	" " =	"	12,000 pTj (with 1.5 multip.)
3.	" " =	"	9,000 pTj (" 2 ")
4.	40% ACC = $	1,200,000 or	$24,000 pdj (w/o ind.)
5.	" "	"	18,000 pTj (with 1.5 multip.)
6.	" "	"	12,000 pTj (" 2 ")
7.	50% ACC = $	1,500,000 or	$30,000 pj (w/o indirect)
8.	" "	"	22,500 pTj (with 1.5 multip.)
9.	" "	"	15,000 pTj (" 2 ")
10.	80% ACC = $	2,400,000 or	$48,000 pdj (w/o indirect)
11.	" "	"	36,000 pTj (with 1.5 multip.)
12.	" "	"	24,000 pTj (" 2 ")

* per direct job created

** per total jobs created (direct and identifiable indirect)

*** multiplier


Benefit
Cap. Cost
$ %
000 CC
3000 100
75
1500 50
1050 35
900
750 25
600
450 15
300 10
30% P/S P&L S/CG 6:1
30% P/S 4:1
30% P/S 3:1
30% P/S 2:1
20% P/S 3:1
20% P/S 2:1
10% P/S 1:1
30% P/S 2:1
10% P/S 05:1
30%
Profit / Sales
Sales / Cap. Cost
20 2:1
15 3:1
15% 2:1
10% 3:1
10% 2:1
30 05:1
25 33 50 66 75 100% Per cent of Tax Liability
10 13.2 20 26.4 30 40% Per cent of Profit before Tax
Incentive Basis as Percent of Tax Liability
or Profit before Tax (@ 40% tax rate -- the current main rate for Manuf.

APPENDIX II

TAX ALLOWANCES - brief comments

Types: (1) Capital Cost Rates - special rates
(2) Capital Cost Amounts - increased amounts claimable

I. Capital Cost Rates:

(1) Value can be affected by national programs.

(2) It is possible to design in such a way as to provide a regional supplement, but such is probably only acceptable with the greatest support. Discard, therefore, as a general mechanism.

(3) It is possible to include tax allowances as a residual mechanism, which might be used.

i.e.	Double the rate	20% → 40%
	Half higher	20% → 30%
	Straight Line (S.L.)	substitute a Straight Line approach for diminishing balance
	Special Rates	20% db → 50% SL
		20% db → 20% SL
		20% db → 33% SL

II. Capital Cost Amounts:

(1) An asset could have its original capital cost increased for purposes of capital cost allowances. Illustrations would include a double allowance, whereby an asset with an original capital cost of $100,000 was given a $200,000 claimable allowance; a 50% increase would yield $150,000 claimable allowance.

(2) Increases in allowances would be subject to the following considerations:

(a) A varying impact or value would be experienced since firms have different tax rates.

(b) The firms would have different levels of profit and only some of the increased allowance could be taken in certain instances.

(3) "Big" vs "small" argument would be presented.

(4) Interpretation for administration should be simple enough although Tax regs. would be complicated and possibly the Act would require revision.

III. Examples of Allowances showing Value as per cent of Capital Cost:

Some illustrations of the value of different capital cost allowance rates are shown on the attachments.

Obviously the value would vary significantly according to whether the maximum allowance could be taken. As well, even though the maximum could be taken, a firm might choose to take a lesser amount in order to give it more freedom later on.

In the basic example, a 50% tax rate has been used as being a useful long-term tax rate. Clearly, this is subject to the actual tax rates which might be experienced. Variations have been included for the current 40% rate for manufacturing and processing and also for the small business rate of 20% at present. Simple variations could be made for the non-manufacturing rates, which are currently in the order of 46%. Needless to say, variations have not been included for:

(a) Provincial variables, and

(b) especially whether or not provinces would recognize such allowances (normally eight of the provinces would be expected to follow suit because of the nature of the provincial tax agreement at present in use).

BASIC EXAMPLE

Impact Assumptions (i) Maximum taken
(ii) 50% tax rate (except as shown)

CCA Class	Rate of CCA	Value of CCA		Share of Total Investment		% of Total Capital Cost
8	Normal	33%	×	60%	=	19.8 Pts.
3	Normal	16%		25%		4.0
10	Normal	37%		10%		4.0
Non-depreciable items		-		5%		-
				100%		27.8 Pts.

Variation 1 - 40% tax rate

8	Normal	26%		60%		15.6 Pts.
3	Normal	12%		25%		3.0
10	Normal	29%		10%		2.9
Non-depreciable items		-		5%		-
				100%		21.5

Variation 2 - Bldg. predominant

8	Normal	33%		20%		6.6 Pts.
3	Normal	16%		65%		10.4
10	Normal	37%		10%		3.7
Non-depreciable items		-		5%		-
				100%		20.7

Variation 3 - Special Capital Cost Allowance Rates

CCA Class	Rate of CCA	Value of CCA	Share of Total Investment	% of Total Capital Cost
29	Special	43%	60%	25.8 Pts.
3	Normal	16%	25%	4.0
10	Normal	37%	10%	4.0
Non-depreciable items		-	5%	-
			100%	33.8

Variation 4 (40% Tax Rate and Special Capital Cost Allowance)

29	Special	34.4 %	60%	20.6
3	Normal	12.8	25%	3.2
10	Normal	29.6	10%	3.0
Non-depreciable items		-	5%	-
			100%	26.8

Variation 5 (20% Tax Rate)

Building predominant	20.7 x .5	=	10.3 Pts.

Variation 6

Special capital cost allowance (29)	26.8 x .5	=	13.4 Pts.

APPENDIX III

Cost-Oriented Incentive

1) Premium on labour costs

30% p.a. for 4 years = $1,000,000 p.v.
= 50% capital cost
= $ 6,666 per direct job

This level of cost would be merited for very exceptional priority labour-intensive industries with uncertain labour costs.

The type of incentive would merit the extra operating costs.

2) Premium on labour costs plus capital cost based grant

20% p.a. for 4 years = $666,666 p.v.
20% ACC = 400,000
$1,066,666
= 53% of capital cost
= $7,100 per direct job

This combination would be merited where labour costs were uncertain but less sensitive than in #1 above.

APPENDIX IV

INVESTMENT RESERVES

Investment reserves and credits may be a useful tool for consideration in Canada even though one particular scheme used in Sweden may be somewhat premature in view of the entrepreneurial/Government climate in Canada.

A number of alternatives may be considered, of which the following two have particular interest:

(1) Reinvestment credits based on earlier investments.

(2) Investment reserves from taxable profits which are then used in relation to investment decisions.

The latter is treated briefly hereunder in view of its greater sensitivity within the Canadian climate.

Swedish Investment Reserve System

The Swedish system was primarly designed as a national anti-cyclical measure. In more recent years it has been given an additional dimension as a tool for regional location.

While variations have taken place down through the decades, it is possible to outline the system briefly as follows:

- A firm voluntarily agrees to put funds into an investment reserve.
- A firm may reserve up to 40% of pre-tax profits in a normal year.
- Of the amount reserved, 46% is paid into an account in the National Bank (which draws no interest) and 54% is retained in the accounts of the firm and may be used as working capital.

- The total reserve is "blocked off" from use except with the express approval of the Government or after a period of 5 years 30% may be used for certain investments.
- The firm avoids paying tax on the portion deposited with the National Bank, unless it uses the funds without authority, in which case a penalty is levied (prior to 5 yrs)
- When investment resources are authorized, the funds may be used by the firm to the extent specified with withdrawals taking place as desired.
- The firm draws a tax credit against taxable income of 10% of the reserves used.
- The capital cost allowance privileges are decreased by the amount of the authorized reserve used.
- The tax rate may vary from the appropriation rate; in which case a firm receives an additional benefit, if higher.
- In certain years, in order to provide greater stimulation, the Government may add a further supplement such as permitting the whole 100% of the reserve to be deposited with the national Bank, thereby increasing the amount of the reserves being utilized by the firm.

<u>The system permits</u>:

(1) The Government to influence and even control investment.

(2) It is an extremely flexible instrument since objectives may be varied from time to time and individual approvals are required within the five year period.

(3) The firm is a party to the investment decision (although

there was a special rider which could cause investment to be compulsory.

(4) The system as applied is controllable for budgetary purposes under 5 years.

(5) Since the system is voluntary at the outset, it is a positive type of instrument in the field of Government - enterprise relationships.

Reinvestment Reserves

It would appear at the present time somewhat premature to consider introducing a program of investment reserves similar to that use in Sweden. Both the temperament of the private sector and the greatness of the distances in Canada mitigate against a transplant of the Swedish mechanism. On the other hand it is abundantly clear that Canada needs to start introducing better land utilization policy and that such would call for less concentration of population in large metropolitan centres and in the agricultural lands of Ontario. It would appear that the time is imminent for the introduction of a voluntary system which would be useful in achieving such changes in direction. It would be most logical to introduce a significant regional component into such a national policy. However, such a development appears to be several years away and at this time it is merely logical to conclude that consideration should be given (a) to developing a system for introduction and (b) to focussing attention in this direction so that national policy can take shape more quickly.

However, the importance of using incentives which can be used to focuss attention and facilitate examination of the opportuniti which are present in the designated regions should be stressed. Development of the incentive grants and tax credit referred to herein ca fulfill this achievement with less resistance, although the use of both the incentives and reserves approach will provide a stronger thrust in the direction of more regional location decisions.

Illustration of Swedish Reserve System

On PBT of $2.5 m firm may receive 40% or $1.0 m in a normal year.*

1. Firm immediately gets benefit of the difference in the tax rate(s) and the percentage required to be deposited.
   3% (49 vs 46%) of $1 m = $30,000

2. Firm gets tax break on approval of investment proposal as follows:

   (a) after 5 years = 30% x $1m x 46% discounted
   = $300,000 x 46% discounted
   = $138,000 discounted
   = 85,555 discounted to .62

   (b) after 0 years = 100% x $1m x 46%
   = $460,000

   Thus range is from $85,555 pv. (or less if 6 years) to $460,000 pv. depending on the timing.

3. Firm gets a bonus of 10% (of reserved authorized) against taxable income in the following year.
   Thus 10% x $1,000,000 x 49% x (.91 to .62) = $44,590 to $30,000.

4. In summary the benefit ranges from $534,590 pv. at year 0 to $145,555 pv. at year 5.

   This yields over 116% of the deposited reserve and almost 100% of the frozen working capital for a yr. 0 project and down to 1/3 and 1/4 of the respective reserves for a year 5 project.

Whether CCA privileges are lost or not depends on the time, source,

* One year a firm could deposit the whole 100% of its reserve for which it got a T.C. of 12% or 8% of Taxable Income or 5.5% or

etc. Assuming that such were lost completely on the investment the reduction would be in the order of 25% of the total investment reserve. Thus the aforementioned figures would drop significantly.

It would appear that this program could be a meaningful tool for regional development.

APPENDIX V

Industrial Variations of Production Factors, etc.

The tables below identify a number* of industrial averages which serve to illustrate the wide range of production and output factors which should be taken into account in the development of a long term incentives proposal.

It is not intended to discuss this at this stage, but rather to highlight the differences reflected. Needless to say, a table of averages is not the same as a table including a frequency distribution but the latter is available only on a limited basis - that is for manufacturing and processing industries which have actually been the subject of a regional incentive.

Table (a)

Industry	Sales** ($M)	Fixed Assets*** ($M)	Sales / Fixed Assets
Manufacturing Service	57.5	19.7	2.9
Agriculture	0.7	0.7	0
Forestry	0.3	0.2	1.5
Fishing	-	-	-
Mining	5.3	10.4	0.5
Construction	9.3	1.6	5.8
Utilities	4.0	33.5	0.1
Wholesale	26.3	2.1	12.5
Retail	23.9	2.1	11.4
Finance	1.1	13.7	0.1
Services	2.7	3.5	0.8
Total	131.1	87.7	

* Only Sales/Net Capital Cost ratio included here

** Products

*** Net Capital Cost

Source - Statistics Canada - Corporation Financial Statistics
- 61.207 Annual

Table (b)

Manufacturing Industries

	Sales* ($M)	Fixed Assets ($M)	Sales / Fixed Assets
Food Industry	8.5	1.3	6.5
Fish Processing			
Beverages	1.4	0.5	2.8
Tobacco Products	0.5	0.1	5.0
Rubber & Plastics	0.9	0.2	4.5
Leather	0.4	-	-
Textiles	1.8	0.6	3.0
Knitting	0.4	0.1	4.0
Clothing	1.5	0.1	15.0
Wood	2.0	0.8	2.5
Furniture & Fixtures	0.7	0.1	7.0
Paper Allied	4.8	3.7	1.3
Printing, Publishing & Allied	1.0	0.4	2.5
Primary Metal	3.5	2.4	1.5
Metal Fabricating	3.7	0.7	5.3
Machinery (except Electrical)	2.5	0.5	5.0
Transportation Equipment	8.7	1.3	6.7
Electrical Products	3.5	0.9	3.9
Non-Metallic Mineral Products	1.6	0.9	1.8
Petroleum & Coal Products	5.2	3.5	1.5
Chemical & Chemical Products	3.3	1.3	2.5
Miscellaneous	1.6	0.3	5.3
Other Miscellaneous			
Total	57.5	19.7	

* Only Sales/Net Capital Cost ratio included here

Source - Statistics Canada - Corporation Financial Statistics
- 61.207 Annual

APPENDIX VI

	1963 TAX INCENTIVES		1965 ADIA INCENTIVES	
Cost of Fixed Assets	#	%	#	%
a) Under 20%	29	16.4	68	8.9
b) 20% to 29%	20	11.3	386	50.1
c) 30% to 39%	25	14.1	316	41.0
d) 40% to 49%	16	9.0	-	-
e) 50% to 79%	29	16.4	-	-
f) 80% or over	58	32.8	-	-
	177	100.0	770	100.0
Cost of Jobs				
a) under $1000	13	7.3	126	16.4
b) 1,000 to 1,999	11	6.2	154	20.0
c) 2,000 to 4,999	27	15.3	255	33.2
d) 5,000 to 9,999	32	18.1	130	16.9
e) 10,000 to 19,999	38	21.5	67	8.7
f) 20,000 to 49,999	40	22.6	33	4.3
g) 50,000 or over	16	9.0	3	.4
	177	100.0	768	100.0

Tax Holiday Benefit (175 Cases)

Cost per Capital Costs

		#	%
(a)	under 20%	42	24.0
(b)	20% to 29%	24	13.7
(c)	30% to 39%	17	9.7
(d)	40% to 49%	10	5.7
(e)	50% to 79%	22	12.4
(f)	80% or over	60	34
		175	100

Cost of Jobs

		#	%
a)	under $ 999	23	13.1
b)	1 000 to 1,999	9	5.1
c)	2 000 to 4 999	29	16.5
d)	5 000 to 9 999	42	24.0
e)	10 000 to 19 999	30	17.1
f)	20 000 to 49 999	34	19.4
g)	50 000 or over	8	4.5
		175	100

APPENDIX VII

Illustrative Option Package

It is useful for clarification purposes to provide a sample package of incentive options which could be made available under a 10 year program.

The type of options available in the package would not necessarily be used at any one time but it should be possible for the various elements to be used throughout the time period subject to such incentive decisions - as contrasted with legislative - as are appropriate.

It is only necessary to emphasize that this package is set out below in order to provide a perspective and also to clarify thinking. In particular, it is necessary to emphasize that the possible B type of incentives may vary widely from those actually to be proposed by B group.

Illustrative Option Package

B Group

1. X% C.C. (incl. Repayable Incentive)
   Y% C.C. % W & S for 3 years
   Z% C.E.

2. 3% Interest

3. Loan Guarantee

C Group

1. X% Profits before Tax (after dep.)* for 8 years

2. Y% Profits before Tax for 8 years
   with advance payment equal to 25% ACC
   upon construction billing.

3. Z% Profits before Tax for 8 years
   plus
   30% ACC
   ceiling $30,000 gross cost per direct job.

4. Z% Profits
   plus
   30% ACC
   plus
   10% of profits if second phase undertaken within 5 years of CP #1

   or X % of ACC (in lieu)

5. Special Capital Cost Allowance rate for general investment stimulator or alternately % increase over 100% allowance rate.

APPENDIX VIII

WORK LOAD MEASUREMENT

Rough 'Guestimate'

	Application Evaluation			Offers Monitoring About 40-50%			Performance 30-33%			
1. Current Standards	Per Cent	Man Days	Total Man Days	Cases	Man Days	Total Man Days	Cases	Man Days	Total Man Days	
A	55	3	165	27	2	54	18	4	72	
B	35	5	175	17	2	34	12	4	48	
C	10	10	100	4	2	8	4	4	16	
	100		440	48		96	34		136	672
2. Conversion to Proposal										
(a) "Undisplaced" large cases			50			4			8	62
(b) Potential displaced by new proposal - larger cases.			50			4			8	
Adjustment Factor			1.5			1.25			6*	
(c) New Approach Workload			75			6			48	129
Total Large			125			10			56	191
" Other										548
" All										739