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Labour-sponsored Funds

Key Players in Innovation, Economic Growth and the Creation of Quality, Quality Jobs for Canada

BRIEF TO THE
STANDING HOUSE OF COMMONS COMMITTEE ON FINANCE
AUGUST 12, 2011

WHO WE ARE

Created by a statute passed in the Quebec National Assembly in 1995, Fondaction, the Confederation of National Trade Union's development fund for cooperation and employment, is a labour-sponsored fund that couples the tax benefits of registered retirement savings plans with tax credits for investment funds dedicated to maintaining and creating jobs.

SUMMARY OF MISSION

Fondaction invests at least 60% of its assets in Quebec businesses in order help maintain and create jobs in an environment that is in line with the objectives of sustainable development. Fondaction serves more specifically businesses that use participatory management, cooperatives and other enterprises in the social economy, as well as SMEs whose decisions or activities help protect or improve the quality of the environment.

ORIENTATIONS

Fondaction is an independent financial institution which, as a socially responsible financial institution that fosters sustainable development, stands out because of the importance it attaches to overall performance and the three types of accountability (economic, social and environmental).

Fondaction's third report on sustainable development (2008-2010) was reviewed by an independent auditor, Samson Bélair/Deloitte and Touche, LLP; the auditor gave an A+ rating to application of the Global Reporting Initiative (GRI). Fondaction is the first financial institution in Quebec that uses the general public's savings to be held to such standards of stringency and transparency regarding both its governance and its economic, social and environmental performance in respect of its internal and external stakeholders.

STATISTICS ON FONDACTION

At May 31, 2011, Fondaction had:

- 107,320 shareholders;
- net assets of $843.2 million;
- development capital investments of $572.5 million;
- In accordance with the legal requirements, these investments are in SMEs whose assets are less than $100 million and net assets are less than $50 million.

SUMMARY

What can be done to ensure sustained economic recovery in Canada?

Our brief recommends that in its next budget, the federal government take the global economic situation into consideration. The fact that we are talking "economic recovery" three years after the 2008 financial and economic crisis and the economy's performance in recent weeks has been troubling should indicate the direction the Government of Canada ought to take.

Recommendation 1. Beware of "double dipping"

Fondaction welcomes the statement made by the federal Minister of Finance, Honourable Jim Flaherty, during a press conference in Toronto on August 2, 2011: "We need to ensure this fragile economic recovery is not endangered by sudden, or dramatic, or draconian moves." It is therefore important to use **extreme caution** in the next budget. The risk of a double dip is high, and recent history tells us that when that type of recession occurs, the second dip is much worse than the first.

What can be done to create sustainable, quality jobs?

It is important to highlight the role of SMEs, in particular innovative start-ups and venture capital and development funds, in creating sustainable, quality jobs. In the context of the financial and economic crisis that started in 2008, labour-sponsored funds played a key role. After three consecutive years of decline, and as fundraising for venture capital in 2010 in Canada fell to its lowest level in 16 years, the amount of money raised by tax-advantaged funds was growing.

Recommendation 2. Development and venture capital

In order to contribute to the creation of sustainable, quality jobs and position the Canadian economy in the new economy, Fondaction recommends that the Government of Canada maintain the credit for shares in labour-sponsored funds.

By doing that, the government would:

- preserve a strong incentive for Canadian households to save;
- ensure ongoing fundraising of development and venture capital and the continuation of investment in innovative start-ups and other Canadian SMEs.

To further illustrate our comments, we gave the concrete example of Fondaction's initiatives in the innovative wood industry for commercial multi-storey construction. The opening of our new "all-wood" six-storey building in Quebec City in 2010 was an opportunity to identify a number of cultural, institutional and regulatory constraints.

We are taking advantage of this brief to share our experience with the Standing Committee on Finance and make a recommendation.

Recommendation 3. Reduce constraints on the use of wood as a building material

To permit new uses of wood in the construction of multi-storey non-residential buildings, we recommend that the Government of Canada:

- give more consideration to the characteristics of wood when the National Building Code is revised;
- make provision for new marketing efforts aimed at increasing the market shares of new products.

Finally, with a view to helping establish Canada's position in one of the growth sectors in the new economy, namely clean technologies, and improving its ability to grasp the many market opportunities that will arise both in Canada and in other parts of the world, Fondaction urges the federal government to step up its efforts in this strategic area.

Recommendation 4. Strategy for the clean technologies sector

Fondaction recommends that the federal government, in partnership with the primary stakeholders in each province of Canada, adopt a **clear and ambitious strategy for developing clean technologies**.

WHAT CAN BE DONE TO ENSURE SUSTAINED ECONOMIC RECOVERY IN CANADA?

The least that can be said is that the economy is a matter of concern right now. Considering the public debt crisis in many Euro zone countries, the American debt crisis, inflationary pressures in many emerging countries that are forcing them to raise their key interest rates, not to mention the latest economic data, which point to a significant downturn in the global economy, we have nothing to cheer about. Moreover, the budget restraint plans being rolled out in Europe and by our neighbour to the south will further reduce global demand at a time when consumer spending and private investment are slow to pick up the ball. If worldwide economic conditions continue to worsen because countries will have spent most of their monetary and budgetary arsenal, governments and monetary authorities in the major developed countries will be put in a very uncomfortable position.

Canada has fared well so far. The Canadian economy weathered the financial and economic crisis. Nevertheless, our dependence on exports, coupled with the current strength of Canadian dollar, is weakening the situation. In the same vein, knowing that consumer spending accounts for more than 60% of Canada's gross domestic product, the high level of household debt in Canada raises major concerns.[1] Despite its strong rebound since the end of 2009, business fixed income, which accounts for 17% of the gross domestic product, had recovered only two thirds of the loss sustained during the recession that began in 2008.[2]

Fondaction is of the opinion that in these circumstances, the Government of Canada needs to be more cautious.

WHAT CAN BE DONE TO CREATE SUSTAINABLE, QUALITY JOBS?

The latest studies confirm the role played by small businesses in the creation of new jobs,[3] in particular the strategic and determining role and development of innovative start-ups.[4] However, we would be sadly mistaken if we were to ignore the employment situation in "mature" businesses. The fact is that the majority of Canadians are employed by mature businesses.[5] It would be equally unforgiveable to fail to recognize the role and importance of social economy businesses.[6]

If our goal is to create sustainable, quality jobs, we have to:

- create conditions conducive to the emergence of innovative start-ups;
- support the development of these "sprouts";
- urge mature businesses (especially SMEs) to invest in modernization so that they preserve their market position.

Fondaction sums up this goal as follows: **make INNOVATION – both technological and social – the core of Canada's economic development strategy and do so in accordance with the principles of sustainable development**.

However, innovation requires adequate funding. Despite their potential in terms of innovation and job creation, small businesses very often have trouble raising capital and bank financing. This is where venture capital and development funds come into play. These funds provide the financial leverage needed to start and expand the projects that have the most potential. Given the wide range of funding needs, businesses have to be able to rely on private specialized funds that work with labour, Crown corporations, university research development corporations and providential investors: [TRANSLATION] *This sort of investor network will provide a fully diversified supply of capital and advice for businesses, regardless of the sector in which they operate, their stage of development or their geographic location.*[7]

A recent study by Brander, Du and Hellmann[8] confirmed that tax-advantaged funds are one of the ingredients needed to stimulate innovation and create values and sustainable, quality jobs. Using a database containing almost 22,000 businesses in 25 countries that had received funding from venture capital funds between 2000 and 2008, they concluded that the businesses that perform best are the ones that receive funding from independent private funds and government-supported funds (the authors of the study cite labour-sponsored funds in Canada as an example).

It is important also to highlight the stabilizing role played by labour-sponsored funds within the Canadian venture capital and development fund industry. New capital commitments from independent private funds decreased from $719 million in 2008 to $597 million in 2009 and $450 million in 2010. Tax-advantaged funds, meanwhile, have increased steadily, from $296 million in 2008 to $336 million in 2009 and $408 million in 2010.[9] Knowing that in 2010, venture capital fundraising in Canada was the lowest it had been in 16 years, this demonstrates the need to keep labour-sponsored funds as a source of capital.

We would like to draw your attention to an example of innovation involving Fondaction. In the spring of 2010, we opened a new "all-wood" six-storey building in Quebec City. The first of its kind in North America, the building shows that wood is a product of the future. Our building captured a great deal of attention, as witnessed by the many awards it received, among them first place in the commercial building category at the Design & Build with FSC Awards 2010.[10] However, we had to overcome numerous constraints in carrying out the project. We are certain that the Government of Canada can play a role in reducing or even eliminating many of those constraints.

Finally, we believe that Canada needs to develop the clean technologies sector more quickly. A number of studies have identified the sector's potential to create sustainable, quality jobs. Canada has everything it needs to be a leader in this area, but we have to quickly realize that we are in race against the clock with other economic powers. Time is pressing. The federal government has to clearly recognize this sector by adopting an ambitious strategy that includes targets and a tight deadline.

WHAT CAN BE DONE TO KEEP TAX RATES RELATIVELY LOW?

More than a thousand years ago, the great Greek philosopher Plutarch reminded us that *"an imbalance between rich and poor is the oldest and fatal ailment of all republics."* It is with that statement in mind that we begin the section part of our brief.

First of all, let us seize this opportunity to look at the other great mission of labour-sponsored funds, which is to collect retirement savings not only from workers, but from the general public as well. Canada's pension plan may be one of the best in the world,[11] but Canadians are increasingly responsible for funding their retirement themselves. Between 1992 and 2006, the proportion of private pension plans in the average income of Canadians 65 or older increased from 23% to 32% of their total income. On the other hand, coverage by defined-benefit pension plans decreased from 41% in 1991 to 30% in 2006.[12] At the same time, household debt in Canada rose to record highs, while the savings rate was only 4% of disposal income.[13] Canada's middle class is in a particularly alarming situation. We would like to draw your attention to two things which we believe are essential in dealing with this problem.

- The importance of workplace retirement savings

We read with great interest the brief from the Canadian Federation of Independent Business titled *Retirement Income in Canada: SMEs' [ers[ectives on retirement income and PRPPs* (March 2011). Our aim is not to comment on the findings of or positions stated in that brief, which are based on a survey of more than 7,800 SMEs in Canada. However, the answers to many of the questions they were asked are definitely of interest to us. Seventy-eight percent of the SMEs said that they no longer offer their employees a retirement savings plan. One quarter stated the reason is that they do not know which end to start at or that the plans are not suited to their situation.

Even more interesting is that almost 60% of the businesses that offer their employees a retirement savings plan opted for a pooled RRSP. Given that small businesses employ more than half of Canada's labour force and account for the bulk of direct business investment by labour-sponsored funds, the data from the CFIB survey raise points that need to be closely examined.

It bears keeping in mind that shares in a labour-sponsored fund can be registered in an RRSP. Fondaction offers its shares in 2,000 workplaces in Quebec.

- Increase in income disparity

We at Fondaction are deeply concerned about the growing disparity in household income in Canada. We believe a parallel can be drawn between rising household debt and the low level of savings.[14]

> *"After 20 years of continuous decline, both inequality and poverty rates have increased rapidly in the past 10 years, now reaching levels above the OECD average.""*

That is the subtitle of the country profile on Canada produced by the Organization for Economic Cooperation and Development in 2008 and titled *Growing Unequal? Distribution and Poverty in OECD Countries.*[15] The profile states, "In the last 10 years, the rich have been getting richer leaving both middle and poorer income classes behind. The rich in Canada are particularly rich compared to their counterparts in other countries." The OECD also points out that "*Canada spends less on cash benefits such as unemployment benefits and family benefits than most OEC countries*."

WHAT CAN BE DONE TO BALANCE THE BUDGET?

Apart from the fundamental question of synchronization with the general state of the economy (see the first part of our brief), balancing the budget requires an equitable approach in the effort Canadian households have to make. That is why it is imperative to take into consideration the amount of tax each person is able to pay. We believe this is all the more necessary because income disparity between Canadian households has increased significantly since the early 2000s.

Looking more specifically at the <u>tax credit for shares in a labour-sponsored venture capital corporation</u>, *"[t]his measure was introduced to foster entrepreneurship by encouraging investment by individuals in labour-sponsored venture capital organizations, set up to maintain or create jobs and stimulate the economy. (Budget Papers, 1985)"*[16]

> "*Labour-Sponsored Venture Capital Corporations (LSVCCs) are investment funds, sponsored by unions or other labour organizations, which make venture capital investments in small and medium-sized businesses. A tax credit is provided to individuals for the acquisition of shares of LSVCCs. For 1998 and subsequent years, the rate of the federal tax credit is 15 per cent, up to a maximum credit of $750."*[17]

The cost to the federal government of the tax credit given to Canadians who hold eligible shares in a labour-sponsored fund in 2010 was estimated $125 million.[18] Is this a good investment for the federal government? To our knowledge, there are two studies which shed light on this issue.

First is the study conducted in Quebec by the firms Secor and Regional Data Corporation. According to Michel Girard, financial analyst with the newspaper *La Presse*,

> [TRANSLATION] *"The Secor and RDC study shows that the governments in Quebec City and Ottawa recover the tax credits given to Fonds FTQ shareholders in 4.3 years based solely on the direct tax revenue (taxes) they rake in from the investments in the fund made by SMEs. When SECOR and RDC factor in paratax revenue (workers' compensation, health insurance, Quebec Pension Plan, etc.), they figure that the governments recover their tax credits in 2.7 years."*[19]

The other study was carried out for the British Columbia Ministry of Small Business, Technology and Economic Development by two of Canada's top experts in venture capital with assistance from tax experts from the University of British Columbia and the firm PricewaterhouseCoopers.[20] Here again, the findings speak volumes. The results of the simulation identified a tax multiplier that is 2.92 for the federal government. This means that for every dollar Ottawa pays for tax credits, the Government of Canada collects almost $3 in direct and indirect tax revenue. The conclusions reached by the authors of the study come as no surprise:

> *"We conclude that the venture capital program is fundamentally valuable to the province of British Columbia. While this conclusion is based on a large number of observations, two findings stand out the most: (i) companies in the program generate more taxes than they consume tax credits, and (ii) companies consistently create new jobs. We recommend that the program be at the minimum maintained and ideally strategically expanded*."[21]

Here are two studies, carried out in different contexts by companies and renowned experts, that come to unequivocal conclusions.

CONCLUSION

Labour-sponsored funds are key players in three areas: innovation, economic growth, and the creation of sustainable, quality jobs. In partnership with other stakeholders in finance, we are helping to build and shape the "new economy".

Labour-sponsored funds also play a fundamental role encouraging Canadians to save, more specifically for retirement.

This is why labour-sponsored funds have become front-and-centre economic players in Canada. The tax credit for shares in a venture capital corporation, find in these funds their full and fair purpose.

RECOMMENDATIONS

Recommendation 1. Beware of "double dipping"

Fondaction welcomes the statement made by the federal Minister of Finance, the Honourable Jim Flaherty, during a press conference in Toronto on August 2, 2011: "We need to ensure this fragile economic recovery is not endangered by sudden, or dramatic, or draconian moves."[22] It is therefore important to use extreme caution in the next budget. The risk of a double dip is high, and recent history tells us that when that type of recession occurs, the second dip is much worse than the first.[23]

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NOTES

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[1] See the recent study by the Certified General Accountants Association of Canada titled *A Driving Force No More. Have Canadians Reached Their Limits?*, on the CGA-Canada website.
[2] Bank of Canada. *Monetary Policy Report*, July 2011, p. 14 and Chart 13.

[3] See, *inter alia*, Neumark, David, Brandon Wall and Junfu Zhang. *Do Small Businesses Create More Jobs? New Evidence for the United States from the National Establishment Time Series*, Discussion Paper Series No. 3888, Institute for the Study of Labor, December 2008.

[4] See Haltiwanger, John C., Ron S. Jarmin and Javier Miranda. *Who creates jobs? Small vs Large vs Young*. NBER, Working Paper 16300, August 2010, p. 3.

[5] According to Haltiwanger et al., in 2005, these firms provided more than 75% of the jobs in the United States.

[6] According to J.J. McMurtry (*Living Economics: Canadian Perspectives on the Social Economy, Co-operatives, and Community Economic Development*, Emond Montgomery Publications, 2009), social economy businesses account for 8% of Canada's GDP.

[7] Réseau Capital. *Pour une industrie du capital de risque plus performante*. Brief to the Public Finance Committee (Quebec), February 6, 2004, p. ii. Réseau Capital is the investment capital association in Quebec. Founded in 1989, Réseau Capital has more than 400 members representing not only private capital investment corporations and public tax-advantaged funds, but also banks and insurance companies, accounting firms, law firms and many industry professionals.

[8] Brander, James, Qianqian Du and Thomas Hellmann. *The Effects of Government-Sponsored Venture Capital: International Evidence*. NBER Working Paper No. 16521, November 2010.

[9] Prepared by Thomson Reuters for the Canada's Venture Capital and Private Equity Association. The Canadian venture capital market in the first quarter of 2011 (http://www.canadavc.com/files/Q12011EnglishOverview.pdf).

[10] The Forest Stewardship Council of the United States presents awards annually in recognition of the best construction projects that use FSC-certified wood, a label that ensures quality logging and fair and equitable treatment of Aboriginal persons and forest workers.

[11] See http://www.mercer.fr/press-releases/1397565.

[12] Gougeon, Philippe. *Shifting Pensions. Perspectives on Labour and Income*, Vol. 10, No. 5, May 2009, No. 75-001-X in the Statistics Canada catalogue.

[13] See http://www.statcan.gc.ca/pub/11-010-x/2011005/ct014-eng.htm.

[14] See Catherine Mathieu and Henri Sterdyniak in "La globalisation financière en crise", OFCE (Observatoire français des conjonctures économiques) review, No. 110, July 2009.

[15] OECD (2008). *Growing Unequal? : Income Distribution and Poverty in OECD Countries*. Country note for Canada. http://www.oecd.org/dataoecd/44/48/41525292.pdf.

[16] Department of Finance Canada. *Tax Expenditures and Evaluations 2010, Note to the Estimates Projections 2010*, p. 48. Cat. No: F1-32/2010E-PDF.

[17] Idem.

[18] Department of Finance Canada. *Tax Expenditures and Evaluations 2010, Note to the Estimates Projections 2010*, p. 15. Cat. No.: F1-27/2010-PD.

[19] Michel Girard. 11 milliards d'actions émises, 3 milliards d'impôts économisés. *La Presse Affaires*, Wednesday, August 3, 2011. In the same article, Mr. Girard wrote, [TRANSLATION]*"Critics of labour-sponsored funds refuse to take at face value this type of study of the economic benefits of the Fonds de solidarité in Quebec SMEs. In any event, as far as I know, none of them has managed to show in black and white that tax credits given to shareholders of the Fonds de la FTQ were money wasted*."

[20] Ministry of Small Business, Technology and Economic Development of British Columbia. *An Evaluation of the Venture Capital Program in British Columbia*. June 2010

[21] Hellmann, Thomas, and Paul Schure. *An Evaluation of the Venture Capital Program in British Columbia*: "*We conclude that the venture capital program is fundamentally valuable to the*

province of British Columbia. While this conclusion is based on a large number of observations, two findings stand out the most: (i) companies in the program generate more taxes than they consume tax credits, and (ii) companies consistently create new jobs. We recommend that the program be at the minimum maintained and ideally strategically expanded." See reference in note 17 on p. 6.

[22] See "Flaherty calls for moderate response to government debt", http://cnews.canoe.ca/CNEWS/Politics/2011/08/02/18499971.html .

[23] *"Of the seven recessions that occurred since 1950, five were "double dips" Generally, the recovery triggered by the end of destocking cannot happen, whereas demand (investment and consumer) remains flat or decrease again. In that case, the second drop in activity is longer deeper than the first."* Béatrice Mathieu, *L'angoisse du double plongeon*. L'expansion, September 16, 2002.