TOPIC E

# Is the support system keeping Ontario SMEs small?

Small firms that get older without getting bigger clearly aren't engines of job growth. They may also be a drag on productivity.

Every successful enterprise started out small. SMEs are often how new ideas and innovations come to market.

That's why the conventional wisdom says small is beautiful. But after a certain point, that's no longer the case. Work done for the U.S. National Bureau of Economic Research, for example, shows that the age of a small firm tells a lot about its role in the economy. A firm that starts small and stays that way clearly isn't creating jobs. And the evidence suggests that it is likely to become a drag on productivity.

Experts agree that the right policy environment could both foster start-ups and support their move into bigger leagues.

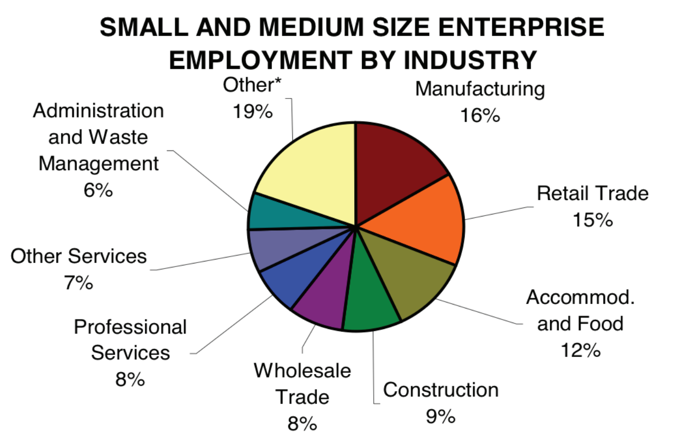
A recent report by TD Financial said that "while small businesses are integral to economic growth, the turnover rate of small firms should be high...if a new business has a smart, innovative idea it should grow quickly to medium or large size, if it doesn't work, it should go out of business quickly and free up resources for others entering the marketplace."

**Why staying small can pay off:**

**Corporate tax rates**. As TD Economics has noted, above a certain threshold, tax rates can more than double, so many Canadian small businesses keep taxable capital under $10M and profits under $500k.

**Scientific Research and Experimental Development (SR&ED)**. This tax credit, intended to spur R&D, favours small business. While it might provide much-needed support for a firm's early work, the fact that that support drops from 35% to 20% as expenditures exceed $3M creates an incentive for research-oriented firms to keep R&D small and focused.

Figure 1.




Source: Industry Canada, June 2005

* The Other categeory is comprised of: Utilities, Mining, Forestry, Finance and Insurance, Informational and Cultural, Transportation and Warehousing, Mgt. of Companies, Arts and Recreation, Real Estate and Rental, and Health Care

**SMEs and the productivity gap: why less is not more**

Research has confirmed that the U.S. outperforms Canada in productivity and business creation, while also having a greater rate of "churning" of new businesses.

One reason for the productivity gap may be because Canadian firms are, on average, smaller than U.S. ones. As Figure 1 shows, those sectors where Canadian firms are systematically smaller than American ones are exactly those where Canadian productivity lags the most, work done for the Bank of Canada noted.

**Payroll Tax**. Businesses with low payrolls avoid this tax altogether. And more employees mean more red tape.

**Capital Gains Exemption**. Limits on lifetime capital gains exemptions encourage firms to keep total assets under $50M.

Work done for the Bank of Canada found that size difference accounts for 20% of the Canada-U.S. labour productivity gap overall, and around 50% of the gap in manufacturing. What's worse is that the problem is increasing: Canada's employment share in large enterprise (500+ employees) has been dropping since the mid-1980s.

> " In Canada, firms with 100 or more employees are 27% more productive than firms with fewer - and in the manufacturing sector this number jumps to 80%."
>
> - Bank of Canada, 2008

Not only do large businesses tend to be more productive than smaller ones, they scale up productivity more efficiently, according to "Productivity in Canada: Does Firm Size Matter?", published in the Bank of Canada Review. They may not have the flexibility and the risk-taking spirit of smaller firms, but in some ways they are nimbler on their feet. Large firms are quicker to innovate in ICT, R&D and labour training, as well as in product and process innovation.

### The keys to large firms' higher productivity:

- The cost of debt and equity is lower for large firms, bringing down the cost of capital
- Large firms tend to pay better and can attract more skilled workers

### Industries where size matters most:

- Transportation and storage
- Arts and recreation
- Wholesale trade
- Commercial and industrial construction
- Mining, oil and gas

### Resources:

- TD Economics: The Productivity Puzzle
- Globe and Mail Report on Business Blog: "Not all small businesses deserve a tax break"
- Bank of Canada Review: Productivity in Canada: Does Firm Size Matter?
- TD Economics: Outlook Positive for Small Business But Challenges Remain