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Competition Policy Review Panel
Research Paper Summary

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Title: How to Attract, Groom and Retain Talent in Canada

Subjects Addressed:

- Matching talent and capital
- Matching seed-funding and Venture-capital with talents
- Canadian income tax regulations
- Investment Canada Act
- Immigration of entrepreneurs
- Impact of income, capital gains and corporate taxes
- Choosing between paying down government debt and returns on investments
- How to grow small and medium-size companies

Treatment of Foreign Investments:
A Global Trends in Venture Capital 2007 survey of venture capital firms world-wide found that 40% of US investors singled out Canada for its unfavourable treatment of investors. This is largely due to regulations and administrative red tape.

The Canada-United States Tax Treaty provides that investors of each country, when investing in the other, will be taxed on investment gains only in the investor's home country. However, US investors in Canada must apply for a clearance certificate under Section 116 of the Income Tax Act when they sell shares in a Canadian company. Every partner in the US Venture Capital firm (sometimes over 100) has to prove their tax-exempt status and has to file a Canadian tax return. 25% of the gross sale proceeds are withheld until the clearance certificate is granted. The 2008 Budget proposed three significant changes to streamline and simplify the compliance process described above.

The Income Tax Act still needs Section 116 to administer tax collected from the sale of Canadian immobile assets: real estate, mineral properties and timber. A way to make the distinction would be to remove from the definition of "taxable Canadian property" in the Income Tax Act shares of a private corporation where such corporation's business is backed by "human capital" based, mobile assets.

If a Canadian company loses its Canadian-controlled Private Corporation (CPCC) status, it loses tax benefits. Companies circumvent this by setting up holding companies if they attract major US investments, but these have legal/administrative costs, which come out of the tax credits and grants received

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for, e.g., R&D. The enhanced Investment Tax Credit (ITC) rate of 35% and partial refundability should be given to all taxpayers, rather than just CCPCs.

Under the Investment Canada Act, investors have to undergo the Net Benefit review and commit to undertakings. This discourages foreign investments in Canada and lowers the value of Canadian companies.

In particular, the ICA discourages foreign bidders in auction settings. They are at a disadvantage because they must obtain Ministerial approval before closing and go through the ICA filings. This can take time. The non-Canadian may either choose not to bid, or the Canadian company may select the local bid because of the timing uncertainty.

Matchmakers – Connecting Talent and Capital:
"Matchmakers" put together talented people with capital, and try to hold all sides accountable. Government grants, subsidies and related programs do not achieve their goals both because bureaucracies are not good matchmakers and because other parts of the fiscal/regulatory system are broken, preventing the commercialization of innovations.

At the early stage of business start-up, when about $100,000- $250,000 are needed, family and friends are the best sources of this seed capital because they are the best judge of a potential entrepreneur. They know the person and can hold him/her accountable.

Reducing income taxes, or raising the brackets for higher tax rates, would allow families and friends to save up money over 10 years to invest in such business start-ups, which are too risky for other sources of capital, since they have an 80% failure rate in the first 5-7 years. Hence, decreasing income taxes would lead to more business start-ups. The $5,000 Tax-Free Savings Account in the 2008 budget is a step in the right direction, but a very small step.

Government funds cannot provide this seed capital successfully, because matchmaking bureaucrats do not know anything about the applicants, unless they happen to be his relatives or acquaintances. Yet disbursing capital based on genetic accident or tribalism does not lead to its best allocation.

High income taxes that prevent families from accumulating savings, and high capital gains taxes that make it more unlikely to expect a positive return, are the two main deterrents to getting new businesses started.

At the second stage of business formation, when roughly $250,000 to $5 million may be required, "Business angels" (private investors with business experience) are needed to evaluate business plans, invest in the most promising ones, and provide mentoring and advice. They are more successful than

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government programs because they have better knowledge of the entrepreneur and provide mentoring.

Tax breaks are less useful, because they complicate the tax codes, increase transaction costs, and lead to a misallocation of funds a) to lawyers and accountants and b) to business ventures that offer tax shelters rather than high prospects of success. If capital is not available at the two early stages, the entrepreneurial talent leaves the country or joins large companies, and the resulting business and managerial "talent deficit" shows up in all subsequent stages, preventing smaller and midsize companies from growing.

Venture Capital – Transforming Innovation into Businesses:
At the next rounds of financing, companies need around $1 to $5 million, then $5 to $10 million, and then $10 to $25 million. Much of this funding is still from VC funds, though US investors come in once a company has proven itself to local funders.

Since 1980, the Labour-Sponsored Venture Capital Corporation (LSVCC) has been the primary government support mechanism for venture capital at the early stages, but it's return has been low because each investment manager has to follow more companies (6.5 as opposed to 2.5 for independent funds) and the business plans were not as well chosen. The ten-year average return on VC funds in Canada was 2.5% - dramatically lagging the US 20.7% and leading to a 30% gap in capital investments as compared to the US (adjusted for population or GDP).

Later on in the business development cycle, stock markets are good matchmakers for large corporations. For example, a reduction in stock prices reflects an expected bad match of a new leader with a company and an increase in stock prices a good match, and the bad matches are corrected relatively fast. Governments cannot replicate this correction process.

Attracting and Retaining the "Vital Few":
An Accenture 2006 study cited half of the Canadian executives surveyed as saying that "inability to retain talent" is their biggest threat. The Canadian government invests in education and R&D, but Canada lacks the 'vital few' or leaders to build winning teams and provide future talent with experience because of the absence of risk-capital.

Countries like Ireland and Israel have flourished due both to a large influx of ambitious immigrants from Poland/Russia, opening up their financial markets, and changing governments programs significantly. In 1986, Ireland slashed spending on health, education, agriculture, roads and housing. It lowered corporate tax rates to 12.5%, at a time when the lowest in Europe averaged 30%, and reduced income taxes drastically. Irish educational statistics suggest though continued mediocrity. Ambitious immigrants were the "vital few" there. The UK's

and Sweden's performance in the last few years is related, in part, to the influx of ambitious young talent from Eastern Europe, too. Since 2004, 500,000 workers from Eastern Europe have registered with the British Home Office, 98% are employed, and 80% are younger than 35.

Israel has been very successful at attracting VC, going from almost none in 1990 to second place world-wide after the US in 1996. Much of the VC is going to high-tech enterprises. The main reasons are that Israel got an influx of 1 million mostly highly-educated Russian immigrants in the early 1990s, adding 20% to its population. By 1998, Israel had 140 scientists and engineers per 10,000 people, being the world leader, followed by the US at 80 per 10,000 and Germany at 55. Israel also has several years of military service, which helps form the critical teams starting up new companies.

Though Canada cannot replicate attracting 10 or 20% of its population within a short time span, it could follow the above countries' fiscal and regulatory changes.

Capital Gains Taxes and Flexibility to Innovate:
Capital gains taxes tend to lock investments in for a longer time, because they impose a cost on switching to a different investment. This reduces the rate innovation. Whereas high income taxes prevent people from accumulating risk capital, high capital gains taxes slow down the mobility of this capital. These two taxes, and also corporate taxes, have the effect of driving out top talent, prevent grooming new one, and slow down the flow of capital. The consequence is that the lesser skilled carry the greatest burden of these taxes – and not the legal entities upon which they are imposed.

Conclusions:
The simpler changes involve adjusting Section 116 of CRA immediately, and with it the issue of the 25% withholding tax, getting rid of the present cumbersome and time-consuming administrative procedures. It has no benefits and there are no tax revenues at stake. Yet they slow down the funding of innovation and growth of start-ups in Canada. The 2008 Budget promised to solve this problem. Although the government would offer a further signal of fundamental shifts in its policies if, as it made the adjustment, it shifted the language of the rewritten Section 116 to the distinction between *"mobile and immobile assets."*

Another change should be made with respect to the tax-free rollovers, allowing Canadian investors to permit such rollovers not only when shares are exchanged between Canadian companies but between any companies. A significant part of Canada's investment in R&D and talented people seems to get mismatched as long as Canada's VC and emerging company industries remain underfunded. US investors, expecting the non-tax free rollovers, will invest less in Canada. The repercussions are significant and show up later in a variety of ways – for a problem that, in part, can find easy technical solutions.

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The 2008 Budget fails to address a recommendation of the Commons Finance Committee – that the enhanced ITC rate of 35% and partial refundability be given to all taxpayers, rather than just CCPCs (the UK already chose to make such a change). As long as the company sustains certain levels of employment (or other measure) in Canada, ownership should be of no concern. The present proposal prevents foreign companies from doing R&D in Canada to start with, and slows down capital flows, and with it the grooming, attracting and retaining of talent. It is a puzzle why the 2008 Budget did not address this issue.

Another simple change would be to get rid of the ICA. Although closer scrutiny of foreign investment when it comes from state-owned funds or seeks to buy into "sensitive sectors" is understandable, the ICA seems duplicative in these instances. Such duplication should be eliminated. In all other instances, its procedures do not stand up to scrutiny.

These four recommendations are – or would be – relatively easy to execute. The ones discussed next, dealing with lasting remedies to create deep pools of risk capital in the country, are more complicated to deal with. We do not have such capital because:

Capital gains taxes were not lowered, whereas elsewhere in the world they were. Also, high income taxes (coming into effect at low brackets) prevent the accumulation of risk capital. The tax-free savings account of $5,000 is a minuscule step, since the contribution is not deductible. Only the gains are not subject to tax. Also, losses from investing the sums people would accumulate are not deductible. The impact of this item in the 2008 Budget on creating risk capital will be marginal.

Corporate taxes were left unchanged too – whereas the rest of the world has been lowering them. There is no recognition in the 2008 budget that the issue isn't some absolute target for tax rates, but rather maintaining flexibility about rates and regulations, and moving swiftly once funds for risk-taking in the country are drying out, and talents moving out.

Handing out money to education, research centres and universities, and having a variety of R&D tax credits and subsidies in place are nice, but without co-ordination with a policy creating deeper "private receptors," not much will happen. The top talent will continue to move out, or be mismatched locally. Only risk capital, domestic or foreign, will enable emerging Canadian companies, whether they are high-tech or life sciences, to grow further. Only by attracting Canadian and foreign institutional funds will the Canadian capital markets deepen and have chances to become "global players."

Even if Canadian taxes were lowered and regulatory burdens lightened, Canadian governments could still spend more and offer better safety nets than many other countries because of a number of reasons. Other countries spend more on the military; have greater internal tensions, and last – but not least - do not have the natural resources that Canada has in abundance and will continue to have, if properly managed.

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Last but not least: there is no reason whatsoever not to lower significantly the various taxes, even if that would increase the government's deficits. Paying down debt, when the yield on Canada's ten-year bond is 3.8%, gives a clear signal that the government expects that leaving more money in Canadian taxpayers' pockets could not bring higher returns. Unless governments pursue reckless inflationary policies, and misspend, it is not true that temporary higher levels of debt bring about higher interest rates. If private returns were even 6 or 8%, the country would be better off lowering taxes and borrowing more at 3.8%, or even at 5%, instead of paying down the debt.