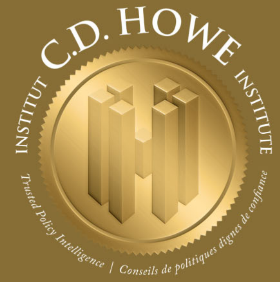
Intelligence MEMOS



Canada's Crown corporations form a major part of the economy, but rarely draw detailed scrutiny. In his latest C.D. Howe Institute Commentary and in this special Intelligence Memo series, ***Fellow-in-Residence*** *Glen Hodgson sets out principles for effective governance for Crowns. Today, we examine the financial dimension.*

From: Glen Hodgson

To: Overseers of Crown Corporations

Date: June 2, 2021

Re: **HOW SHOULD GOVERNMENTS ASSESS CROWN CORPORATION FINANCIAL PERFORMANCE?**

Annual revenues for Crowns, federal provincial and municipal, are equivalent to more than 7 percent of Canada's GDP – larger than all of Atlantic Canada, or Saskatchewan and Manitoba combined. Collectively, they had annual revenues of $162 billion in 2019, but lost $400 million overall. Federal and provincial Crowns had massive net assets of nearly $1.4 trillion in 2019, but modest net worth of about $22.9 billion.

Financial performance should be a priority lens as governments define expectations for each Crown to meet its policy and business objectives. I suggest there are four broad options for setting financial targets.

Ideally, the shareholder government would publicly identify which option applies to each Crown, to be reconfirmed or modified at regular intervals. Doing so would help justify operating subsidies and other support, in addition to reaffirming the Crown's policy purpose and its service to customers.

Option 1: Direct or indirect cost to taxpayers. Some Crowns are service providers of last resort when the unsubsidized private market is not willing to provide a specific service or to serve a specific client base. Others provide a service that is a pure or partial public good. In those cases where operating costs are not fully covered by revenues, an annual operating subsidy is required. VIA Rail and CBC/Radio Canada are prominent examples.

In other cases, revenues might be roughly equal to operating costs over the long term, so no annual operating subsidy is required. However, there may still be an indirect fiscal cost to the shareholder since the government's budget would have to absorb the interest costs on any government debt used to finance the Crown's assets, or to purchase share capital to underpin the business.

In both these cases, the government should assess the cost of the direct or indirect subsidy required to achieve the policy objective as compared to other alternatives for meeting that goal, such as direct government delivery or subsidizing private operators.

Option 2: No cost to taxpayers. A second approach would see a Crown corporation perform as a commercial enterprise without requiring direct or indirect budgetary support from its shareholder. To realize this option, the Crown's long-term return on shareholder equity would need to meet or exceed the long-term cost of capital to the shareholder – which is the government's long bond yield. Long bond yields (10 to 30 years) were typically in the range of 5-6 percent over the past decade, although today's depressed yields would be an easier market benchmark for Crowns to reach.

In these cases, governments should assess the opportunity costs of the capital (and effect on net debt) it has locked into a given Crown (e.g., Ontario Power Generation) and compare the public policy results to other public investments.

Option 3: Positive financial return to taxpayers. Here, a Crown would be expected to achieve a long-term return on shareholder equity that is higher than the long bond yield. This option would be consistent with a Crown that works with the private sector to build overall market capacity. Crowns would be expected to generate material annual profits most of the time and grow retained earnings, which could eliminate the need for further capital injections from government. The Crown could also implement a dividend policy where any "excess" profit or retained earnings could be returned to taxpayers. As with the above option, the opportunity cost of the capital and dividend together should be compared to other ways to deploy public capital and use public spending and tax incentives.

Option 4: Seek to earn a market-based return on shareholder equity. The final option would be a Crown that seeks to be profitable like a private sector firm. Of course, under that option a Crown would likely avoid activities that are not profitable, potentially reducing its public policy role – and building the case for privatization. Realistically, this option could be considered for a mature Crown that has made significant progress in delivering on its policy mandate, or where there has been expansion in private sector capacity to serve the target market. With this financial performance, governments should ask if a fully private, unsubsidized operator would also meet any of the non-financial policy goals, rather than using a Crown.

Applying these financial lenses to each Crown would give greater clarity and guidance on financial expectations as well as the Crown's expected policy and commercial roles.

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