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COMMENTARY

ECONOMIC GROWTH AND INNOVATION

Clearing Hurdles:

Key Reforms to Make Small Business More Successful

Ben Tomlin

In this issue...

Reforming small business taxation would remove major incentives for firms to stay small and make the Canadian economy more competitive overall.

The Study in Brief

Reforming small business taxation would remove major incentives for firms to stay small, encourage their growth and make the Canadian economy more competitive overall. Small businesses face many hardships simply because they are small. Natural economies of scope and scale dictate that the costs of tax and regulatory compliance are higher for smaller business. In an effort to offset these costs, and to make small businesses competitive despite their size, Ottawa and the provinces have established a preferential tax and regulatory system. However, as companies grow, they lose their small business benefits as their asset, employment and income levels surpass certain thresholds. This can both discourage growth – as businesses adjust their decisions to hold on to preferential treatment – and inhibit growth – as businesses looking to grow are faced with increasing costs of operation as preferential treatment is lost. This can have a detrimental effect on Canada's overall growth.

This study outlines a series of policy recommendations aimed at encouraging further growth within the Canadian small business sector. These include: instituting a flat 13 percent federal corporate income tax applicable to all businesses, regardless of size; increasing the scope of investors who can access the capital gains rollover exemption; adjusting collective dismissal laws to ensure that smaller businesses have the flexibility to take on new projects and employees; and, adjusting health and safety committee legislation to account for industry characteristics.

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Economic dynamism – the combination of entrepreneurial drive and the economic institutions that channel it – is the hallmark of modern, successful economies. Having the right financial, fiscal and regulatory frameworks in place to ensure that businesses with the greatest potential are identified and nurtured is an essential element of facilitating overall growth. However, in Canada there exists a series of tax and regulatory policies aimed at improving the prospects of small businesses that may, in fact, be adversely affecting economic dynamism. These policies create incentives for firms to stay small and punish those that try to grow into large, successful businesses that are competitive at the international level.

Small businesses face many hardships simply because they are small. Natural economies of scale and scope dictate that the costs of tax and regulatory compliance are higher for smaller businesses. They also face reduced access to financing due to greater volatility in their performance and high failure rates. Raising capital is more expensive because of higher interest rates on loans and lower prices for equity issues (TCBT 1997).

In an effort to provide relief to small businesses and to allow them to be competitive despite their size, Ottawa and the provinces have instituted a preferential tax system. Numerous favourable tax exemptions, credits and deductions exist to help small business focus on growth rather than survival. However, while it is important to create an environment that allows small business to succeed, the current preferential tax scheme can have negative effects on aggregate growth within the overall economy.

As firms grow, they lose their small business benefits as their asset, employment and income levels surpass certain thresholds. As a result, the same incentives can both discourage and inhibit growth as preferential treatment creates an incentive to stay small. Adding to this problem is the fact that there are several regulatory policies that apply selectively to larger firms, affecting small firms' production choices and growth prospects.

Economic policy should aim to find the right balance between what are sometimes competing objectives: ensuring the competitiveness of small businesses and the facilitation of overall economic growth through smaller enterprises becoming larger, successful firms that compete at the international level.

The first part of this *Commentary* highlights some of the current tax and regulatory policies that affect small business growth and examine how they influence behaviour and innovative activity. The second section provides a series of policy recommendations aimed at encouraging further growth within the Canadian small business sector including:

- Instituting a flat, federal corporate income tax rate of 13 percent that applies to all businesses, regardless of their size.
- Eliminating the capital tax in all provinces.
- Increasing the scope of investors who can access the capital gains rollover exemption for investment in small business.
- Adjusting collective dismissal laws to ensure that they apply only to larger businesses, giving smaller firms the flexibility to take on new projects and employees without becoming subject to collective dismissal liabilities.
- Making health and safety committees voluntary for industries that are deemed low-risk and making them mandatory, but with reduced scope, for medium-risk industries while maintaining the status quo for high-risk industries.

Defining Terms: How Small is Small?

It is important to begin by defining what is meant by the term "small business." Firms are often categorized in terms of their operating revenues, annual sales and shipments, number of employees,

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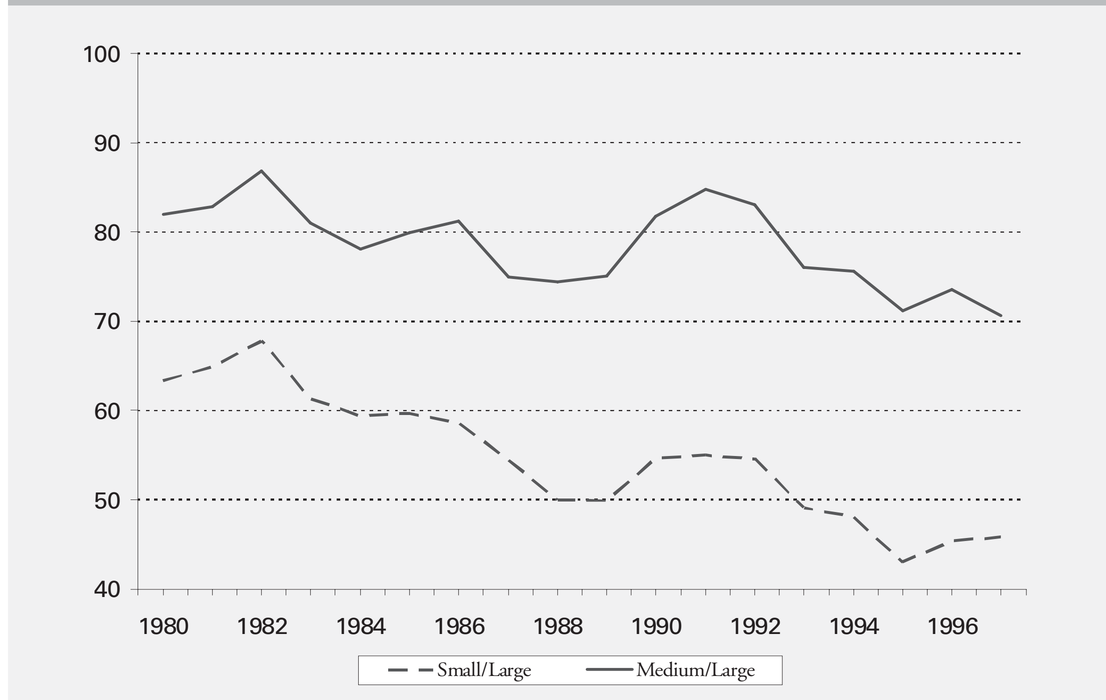
Figure 1: Relative Productivity (Value Added per Employee) of Small-to-Large and Medium-to-Large Manufacturing Plants (Large = 100)



Note: A small plant has fewer than 100 employees; a medium-sized plant between 100 and 500 employees and large plants more than 500 employees.

Source: Baldwin, Jarmin and Tang (2002).

total remuneration or output levels. For the purposes of this *Commentary*, a small business meets at least one of the following conditions: it has fewer than 100 employees, it has less than $10 million in taxable capital, or it has less than $1 million in annual payroll.

Because the tax and regulatory policies addressed below apply selectively when a firm's income, assets, number of employees or employee remuneration fall below certain thresholds, any definition of a small business based on one characteristic is unsatisfactory. Nevertheless, the tax and regulatory policies outlined below were designed specifically to help small businesses, and the definition of a small business provided herein encompasses these policies.

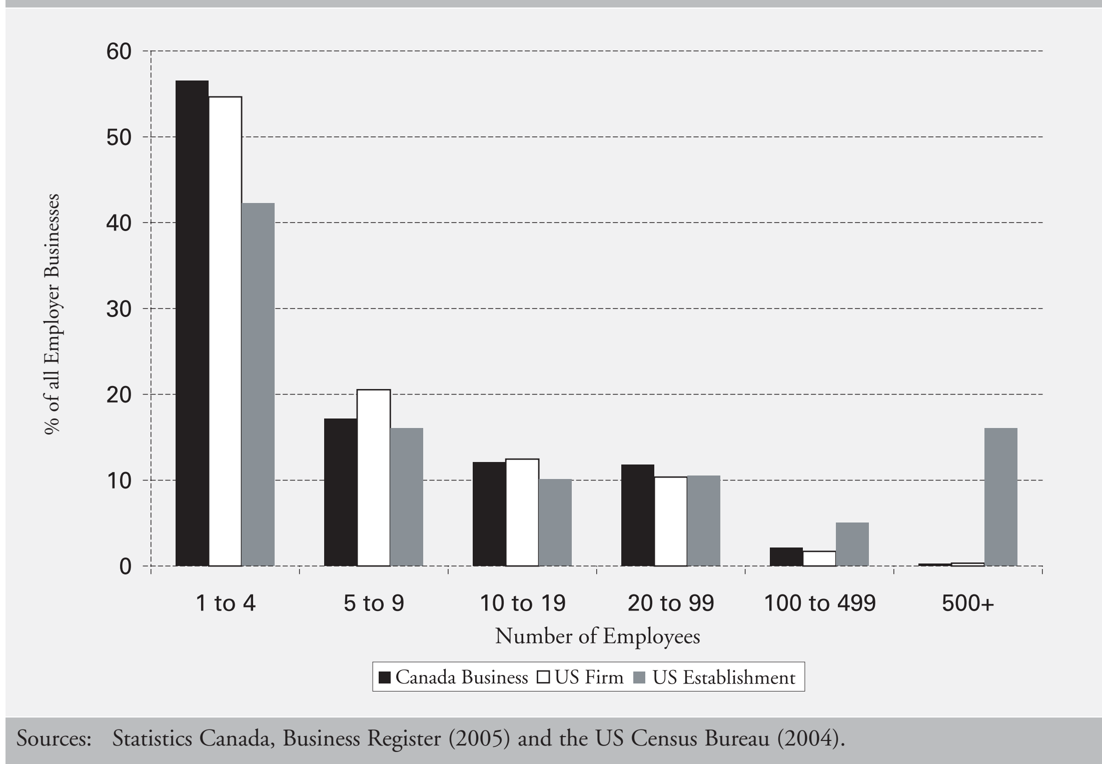
In general, businesses with fewer than 100 employees make up more than 99 percent of all employer businesses in Canada[1] and account for almost 50 percent of all private sector employment (Industry Canada 2008). They also make a significant contribution to the net growth in private sector paid employment. However, it is important to note that most of this growth was due to a sub-group of small enterprises known as hyper- and strong-growth businesses.[2] Outside of this sub-group, the majority of small businesses are not looking to expand. One study found that only 40 percent of small business owners are interested in growth, while the rest are content to stay small (Tal 2006). Therefore, any policy aimed at improving the growth prospects of small businesses must take this into account.

Given the right tax and regulatory policies, many small businesses can develop into large successful companies that are competitive at the

1 An employer business is defined as a business that maintains a payroll of at least one person.

2 The most recent study on this issue found that businesses with fewer than 100 employees, that were in operation throughout the 1993-2003 period, accounted for 60 percent of employment growth among continuing business. A continuing business is defined as a firm that was in operation throughout the period of study. Hyper- and strong-growth small businesses are defined as those continuing businesses that grew more that 50 percent over the 1993-1997 period (Industry Canada 2008).

Figure 2: Distribution of Canadian and US Businesses by Size



Sources: Statistics Canada, Business Register (2005) and the US Census Bureau (2004).

international level. Why is this important? Larger businesses have many desirable characteristics for a healthy, robust economy. For example, larger firms are, in general, more productive than smaller businesses (Figure 1), they offer higher wages – beyond what their higher productivity would imply[3] – and provide more stable employment. Moreover, having a steady flow of new businesses rising to take the place of older companies is an important part of maintaining "creative destruction" in the upper echelons of Canadian business.[4]

Direct international comparisons are difficult, given differences in data collection and the definition of a business. Nevertheless, there is evidence to suggest that the distribution of businesses by firm size is skewed towards smaller businesses in Canada when compared to the United States. The US Census Bureau provides data on the size distribution for businesses in terms of firm and establishment, and neither definition of the business unit fits directly with the Statistics Canada definition of a business.[5] However, in comparing the Canadian data with US establishment data, it is clear that the Canadian economy has proportionately more small businesses than the US and, by the same metric, significantly fewer large (500+ employees) businesses (Figure 2). Is Canada a nation of small shopkeepers? The data is not entirely conclusive, but the Canadian system certainly discourages growth, an issue that policymakers can no longer afford to ignore.

3 Morisette (1993) and Drolet and Morisette (1998) show that after controlling for many observable worker characteristics, a substantial wage differential of around 20 percent exists between small and large firms in Canada. The studies focus on the Canadian commercial sector. Small firms are defined as those with less than 20 employees, while large firms are those with 500 or more employees.

4 See Howitt (2007) for more on the importance of creative destruction.

5 Statistics Canada defines an individual business for the purpose of this measurement as an establishment that produces a homogeneous set of goods or services and does not cross provincial boundaries. The US Census Bureau defines a firm as a business organization consisting of one or more domestic establishments in the same state and industry under common ownership control. For each multi-establishment firm, establishments in the same industry within a state will be counted as one firm. An establishment, on the other hand, is a single physical location where business is conducted or where services or industrial operations are performed.

Table 1: Federal Small Business Limit and Tax Rates

	Limit and Rates					
	2007	2008	2009	2010	2011	2012
Federal small business limit ($000)	400	400	400	400	400	400
Federal small business tax rate (%)	13.12*	11.0	11.0	11.0	11.0	11.0
Federal corporate income tax rate (%)	22.12*	19.5	19.0	18.0	16.5	15.0

*Includes a federal 1.12 percent surtax that was eliminated on Jan. 1, 2008.

Sources: Federal Budget 2008, Economic Statement 2007.

Taxation

Economists argue that the resources smaller companies direct towards tax compliance are resources that could otherwise be used for reinvestment, facilitating future growth. Based on the belief that taxes, and a complex tax system, put disproportionate pressure on smaller businesses and that small businesses are an important part of the economy, a system of tax exemptions, credits and deductions exists in Canada to help small businesses become more competitive. Insofar as the preferential tax provisions have worked to promote a more favourable environment for small businesses – giving them reprieve from onerous tax requirements and allowing them to be competitive despite their size – they can be considered a success. Insofar as they have discouraged the retention of profits for increased internal investment, capital deepening and growth, they may be failing.

Tax provisions that provide targeted relief to smaller businesses create tax thresholds, which in turn create disincentives to growth, lest the subsidy be lost. Who benefits from the tax relief depends on the specific provision but, in general, they relate to asset, profit, employment or remuneration levels. Of particular interest, many of the tax provisions are uniquely offered to Canadian-Controlled Private Corporations (CCPCs),[6] a situation that can impact a firm's decision when to incorporate and become public. The following subsections address some of these tax provisions and their implications.

Small Business Deduction and Tax Integration

The small business deduction (SBD), offered at both the federal and provincial level, provides tax relief to CCPCs that qualify as small businesses. At the federal level the first $400,000 of active business income is subject to a lower rate than the general corporate income tax rate. Currently, the federal corporate income tax rate stands at 19.5 percent, while the reduced rate is 11 percent.

In recent years, there have been many changes to the federal SBD plan – such as moving from a three-tiered to a two-tiered tax system – with more changes to come (see Table 1). The benefits of the

6 A CCPC is generally defined as a company that is not controlled, directly or indirectly in any manner whatsoever, by public corporations, non-residents or a combination of the two. The definition of a "small" CCPC depends on the tax provision.

Table 2: Provincial Corporate Income Tax Rates, 2008

	Threshold for Small Business Deduction ($000)	General Corporate Income Tax Rate (%)	Small Business Tax Rate (%)
Alberta[a]	460	10.0	3.0
British Columbia[b]	400	12.0	4.5
Manitoba[c]	400	14.0	2.0
New Brunswick	400	13.0	5.0
Nfld. and Lab.	400	14.0	5.0
Nova Scotia	400	16.0	5.0
Ontario	500	14.0	5.5
P.E.I.[d]	400	16.0	3.2
Quebec[e]	400	9.9	8.0
Saskatchewan[f]	450	13.0	4.5

a Alberta's 2008 budget increased the threshold from $430,000 to $460,000 effective April 1, 2008. The threshold is set to increase to $500,000 on April 1, 2009.

b On July 1, 2008, the B.C. general corporate income tax rate will decrease to 11 percent, and the small business rate will decrease to 3.5 percent.

c On July 1, 2008 the Manitoba general corporate income tax rate will be reduced to 13 percent.

d The P.E.I. small business rate is set to be reduce by 1.1 percentage points each year until it reaches one percent in 2010.

e Until recently, Quebec did not offer a preferential tax rate for small businesses. In March 2006, the small business tax rate was reduced to 8.0 percent from 8.5 percent. The general corporate income tax rate is to increase incrementally to 11.9 percent by 2009. Manufacturing SMEs in remote resource regions are given a 10-year tax holiday on 50 percent of taxable income in 2008 and 25 percent in 2009 and 2010.

f Saskatchewan's 2008/09 budget has implemented an increase in the threshold from $450,000 to $500,000 effective July 1, 2008. Further, the general corporate income tax rate is set to be reduced to 12 percent on July 1, 2008.

Source: Provincial Budgets.

lower tax rate are clawed back when CCPCs reach $10 million in taxable capital and are fully phased out when capital reaches $15 million.

The $400,000 limit must be shared among any associated group of companies. Once the threshold is surpassed for the group as a whole, the higher rate kicks in for any additional income.

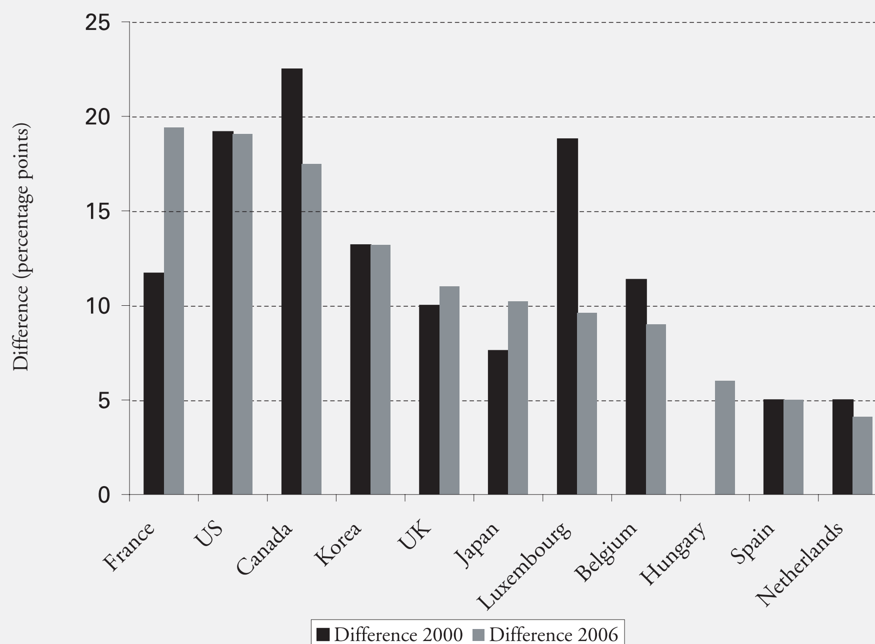
For their part, almost all provinces now have a $400,000 limit (Table 2) for a lower, provincial small business tax rate. Provincial incentives are clawed back at the federal rate. The one exception is Ontario, which has its own clawback mechanism.[7]

Many other countries offer some form of tax relief for smaller businesses. However, few offer the level of preferential treatment, relative to the general tax system, afforded to smaller companies in Canada. In 2006, the combined general corporate rate (36.12 percent) was nearly double the combined small business tax rate (18.62 percent), resulting in a difference of 17.5 percentage points.[8] Of the OECD countries that offer some form of a small business deduction, only France and the United States had a greater difference between the corporate and small business rates – 19.4 and 19.07 percentage points, respectively (Figure 3).

7 At the federal level, the SBD threshold is reduced on a straight-line basis when a business' taxable capital is between $10 million and $15 million. Ontario levies a 4.67 percent surtax on income exceeding $500,000 for CCPCs claiming the Ontario small business deduction in order to gradually phase out the benefit. This results in a phase-out range for the application of the surtax from $500,000 to approximately $1,500,000.

8 "Combined" refers to the combination of central and sub-central government taxes as defined by the OECD (OECD Tax Database 2006).

Figure 3: Percentage-Point Difference Between Combined Corporate and Small Business Tax Rates



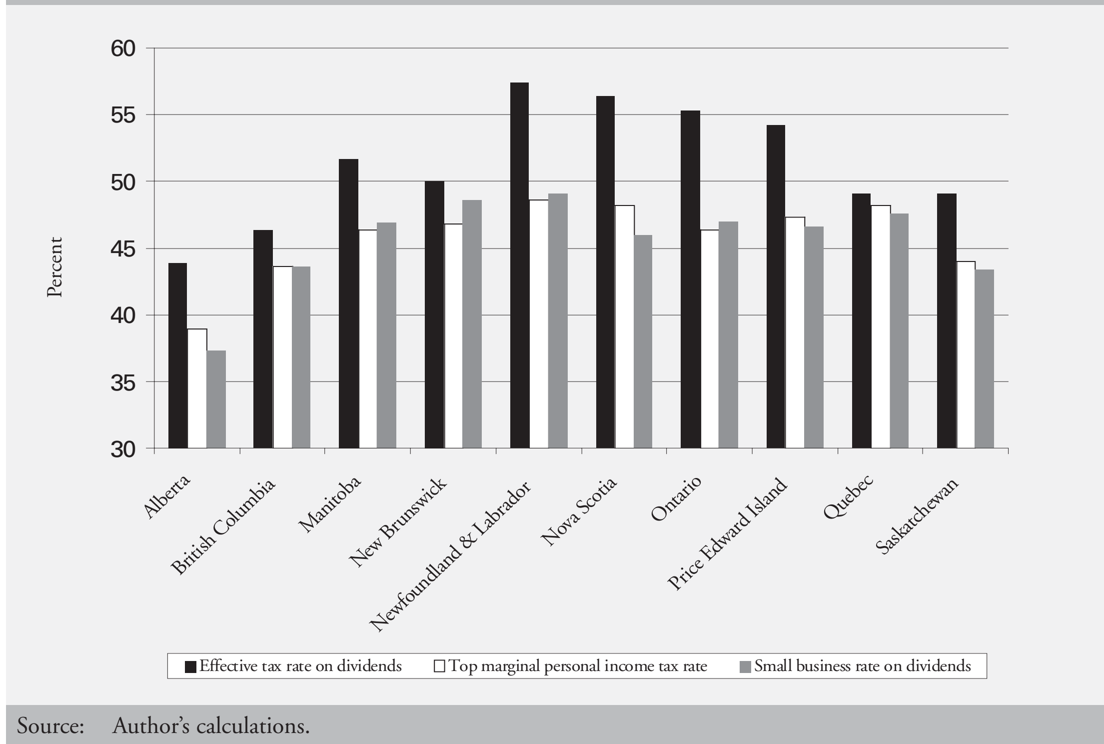
Source: OECD Tax Database, Tables II.1 and II.2. Calculations by author.

Recent changes in the Canadian tax system have narrowed the gap, but a significant differential still exists. And the bigger the difference between the general corporate and small business rates, the bigger the distorting effects it has on business decisions. Preferential treatment of this sort creates an incentive to stay small, as companies actively keep income and assets below the thresholds to benefit from the small business deduction. Moreover, these provisions have long-term effects on growth, as CCPCs have comparatively less access than large companies to public and significant foreign funds. Small businesses are also less likely to take risks – a conservative characteristic associated with private ownership (Brown, Mintz and Wilson 2000).

Beyond offering tax breaks to small CCPCs, the SBD creates one other advantage to remaining small. Income earned at the corporate level is subject to both corporate income tax and, upon distribution as dividends to individuals, personal income tax. This double taxation of dividend income is an incentive for shareholder-managers to remain small. While there is a dividend tax credit system aimed at offsetting some of this double taxation, it does not in most provinces fully account for the corporate taxes before the distribution of dividends. The result is that the tax system is not integrated, meaning the tax paid on dividend income is greater than the tax paid on other forms of income – such as wages and salaries – at their top marginal rates (Figure 4).

However, due to the lower income tax rate offered by the SBD to small CCPCs, corporate and personal income taxes are more or less fully integrated for the first $400,000 of active business income (Figure 4). This can distort business decisions as companies seek ways to avoid the additional "unintegrated" tax paid on equity income. One way to do this is by paying out income in excess of $400,000 as bonuses to shareholder-managers rather than dividends to those individuals in the top tax bracket – a strategy known as "bonusing down." Such bonuses for shareholder-managers are subject to income tax only and can be loaned back to the company if required. This strategy is particularly enticing in Ontario where the unique SBD clawback system makes it unappealing to declare income above the small business threshold.

Figure 4: Tax Rates on the Distribution of Corporate Income (at top marginal personal income tax rates)



Source: Author's calculations.

The small business deduction and the integration for dividend income it provides create an incentive for attaining and retaining small CCPC status (Brown, Mintz and Wilson 2000). In one the few empirical studies on this issue, Hendricks, Amit and Whistler (1997) provide evidence that this preferential treatment has resulted in a strong tax-based incentive for businesses to stay small. First, they found that most CCPCs that were employer businesses in 1992 reported income below $200,000 (what was then the SBD limit) and that the distribution of income earned by businesses showed clustering just below this threshold.[9] Moreover, they found that few CCPCs in a cohort (enterprises born in a given year) or less than one percent over the 1985-1993 period, managed to make the transition to a public company or grow beyond the $200,000 threshold.

In conclusion, the small business deduction introduced to promote the retention of profits for re-investment to facilitate growth may well be having the opposite effect.

Payroll Taxes

Several provinces have small-business exemption policies relating to unique payroll taxes. Ontario's Employer Health Tax (EHT) levies a 1.95 percent tax on annual remuneration paid by private sector employers, other organizations not under the control of government and Crown corporations that are subject to federal income tax. However, the first $400,000 of annual remuneration is exempt from the EHT, and employers with annual payrolls of less than $600,000 are allowed to make one lump-sum payment along with their annual returns instead of the monthly installments required of larger enterprises.

In Newfoundland and Labrador, firms with payrolls less than $600,000 are exempt from paying the province's 2 percent Health and Post

9 The authors found that the number of enterprises reporting income between $150,000 and $200,000 was greater than the number reporting in the $100,000 to $150,000 range. Further, this distribution was in marked contrast to the distribution of taxable income below $100,000 and above $200,000.

Secondary Education Tax.[10] In Manitoba, firms with $1 million or less in remuneration are exempt from the province's Health and Post Secondary Tax, while those with payrolls between $1 million and $2 million are subject to a 4.3 percent tax on the amount in excess of $1 million. Those with payrolls of more than $2 million must pay a 2.15 percent tax on total remuneration. Finally, in Quebec, firms with payrolls of $1 million or less pay a 2.7 percent Health Services Fund tax. The rate increases as firms approach $5 million in remuneration, at which point they pay 4.26 percent.[11]

These taxes and exemption thresholds have a singular relationship with the SBD and tax integration. Even with bonusing down, the bonuses count as remuneration, thus increasing payroll to the eligible level for these taxes. Small business managers must weigh the costs and benefits of bonusing down versus keeping remuneration low to avoid additional payroll taxes.

The exemption schemes for payroll taxes differ slightly from the small business deduction outlined in the last section. In some cases, the payroll exemptions are available to all businesses, regardless of size, instead of being available only to small businesses. Nevertheless, the deduction thresholds can still deter businesses from expanding their workforce or level of remuneration. And nascent companies with few employees can ill-afford increasing tax obligations when survival is still a primary objective.

Capital Taxes

A number of provinces continue to levy a corporate capital tax. The federal government has eliminated its capital tax, but Ontario, Quebec, Manitoba, Saskatchewan, Nova Scotia and New Brunswick still tax paid-up capital, retained earnings and most debt, all of which count towards a firm's taxable capital. Capital taxes are particularly harmful in that they are due, whether or not a business is profitable.

In all the provinces where capital taxes exist, smaller businesses are generally exempt or face lower rates below a given threshold (Table 3). Of note, all provinces are in the process of eliminating their capital tax over the next few years; some sooner than others.

Corporate capital taxes, and their associated exemption thresholds, can discourage investment and growth as businesses become wary of accumulating capital beyond the thresholds. Continued capital deepening – an increase in the capital/labour ratio – is a key characteristic of large, successful enterprises (Baldwin and Gu 2003), and any policy that discourages this will affect adversely the growth of individual businesses. The corporate capital tax with its exemption thresholds does precisely that.

R&D Tax Credit

The federal Scientific Research and Experimental Development (SR&ED) program offers CCPCs investment tax credits at an enhanced rate of 35 percent on the first $3 million of annual qualified R&D expenditures. These benefits are reduced once prior-year taxable capital and income reach certain thresholds. The $3 million expenditure limit is phased out as CCPCs taxable income for the previous year increases from $400,000 to $700,000 or its taxable capital increases from $10 million to $50 million. For qualifying CCPCs, all tax credits earned at the higher 35 percent rate on current expenditures are fully refundable. As well, 40 percent of tax credits earned at the higher 35 percent rate on capital expenditures are refundable.

Since it is available only to small CCPCs that are below certain income and capital thresholds, the SR&ED program becomes a factor in a business's decision concerning investment and

10 For employers with annual payrolls between $600,000 and $700,000, the exemption threshold is phased down to $500,000 as payroll approaches $700,000; i.e., exemption threshold = $600,000 - (total payroll - $600,000).

11 The tax rate that a company is subject to is determined by the following equation: Rate (%) = 2.31 + (0.39xS), where S = total payroll/1,000,000. S = 1 if total payroll ≤ $1 million, and S = $5 if total payroll ≥ $5 million.

Table 3: Corporate Capital Tax Rates and Exemptions (not including banks, trusts and loan companies)

	Tax Rate	Deductible Taxable Capital Amount
Federal	Eliminated effective Jan. 1, 2006.	
Manitoba[a]	0.3% for corporations with taxable paid-up capital between $10 million and $20 million; 0.5% for corporations with taxable paid-up capital more than $20 million.	$10 million
New Brunswick[b]	0.05%	$5 million
Nova Scotia[c]	For firms with taxable capital less $10 million, $5 million is deductible and the rest faces a tax rate of 0.5%. For firms with more than $10 million in taxable capital, there is no deduction and a tax rate of 0.25%.	$10 million
Ontario	Capital tax eliminated for manufacturing and resource corporations. For other corporations, the 0.225% capital tax will be eliminated January 1, 2010.	$15 million
Quebec	Eliminated for manufacturing corporations. For other corporations, the 0.36% capital tax will be eliminated by 2011.	$10 million.
Saskatchewan[d]	0.3%	$20 million

a Manitoba's 2008 budget calls for the elimination of the capital tax for manufacturing and processing corporations on July 1, 2008. For other corporations, the capital tax will be eliminated December 31, 2010.

b New Brunswick's 2008/09 budget calls for the elimination of the capital tax by 2009.

c The Nova Scotia rates will be reduced every fiscal year until the capital tax is eliminated on July 1, 2012.

d The corporate capital tax rate is set to be eliminated on July 1, 2008 (Saskatchewan Budget 2008/09).

Source: Provincial Budgets.

growth. Therefore, the SR&ED program stands as yet another potential impediment to growth.

Lifetime Capital Gains Exemption

The federal government provides a lifetime capital gains exemption for individuals of up to $750,000 for gains from the disposition of qualified small business corporation shares (as well as farm property). To qualify as a small business corporation, a company must be a CCPC and must have all or substantially all its assets used in an active business in Canada. The Canada Customs and Revenue Agency interprets this to mean that assets representing at least 90 percent of the fair market value of all corporate assets must be used for business purposes.

In addition, at least 50 percent of the corporation's assets must have been used in an active business carried on primarily in Canada throughout the 24-month period immediately before the sale. Although the qualifying CCPC can be of any size, these restrictions are intended to make the exemption applicable only to smaller CCPCs.

Capital Gains Rollovers for Small Business Investors

The 2000 Federal Budget introduced another measure benefiting small business investors. Called the capital gains rollover, it enables individuals to defer tax on capital gains from investments in small businesses as long as the proceeds are reinvested in another eligible small business in the year of disposition or within 120 days after the end of that year. There are no limits on the amount of the original investment and reinvestment that may be eligible for the deferral.[12] For the purposes of this tax provision, a small business is defined as a CCPC whose assets do not exceed $50 million immediately after the investment.

This provision is aimed at so-called angel investors, and the objective is to promote innovation and growth by making it easier for small businesses to access the risk capital needed to expand. But because it favours small businesses and is associated with an asset threshold, this exemption will distort decisions of shareholder-managers and investors, as small businesses choose to stay below the threshold to maintain their access to rollover capital.

Regulation

Regulation exists to protect consumers, employees and employers, industries and the environment from what are perceived as market failures – that is, the inability of the market to properly assess, and hence protect, things that we value in our society. However, any amount of market intervention in the form of regulation can have unintended and, sometimes, negative consequences. Quantifying the costs associated with over- and under-regulation is challenging, at best; defining the ideal amount of regulation is nearly impossible.

Smaller businesses are disproportionately burdened by complex regulation since they cannot take advantage of economies of scale and scope to reduce costs that would increase competitiveness. Whereas larger businesses can afford staff devoted to ensuring that they meet complex regulatory requirements, smaller firms must hire outside consultants that are comparatively more expensive. In general: the smaller the business, the heavier the regulatory burden (Figure 5).

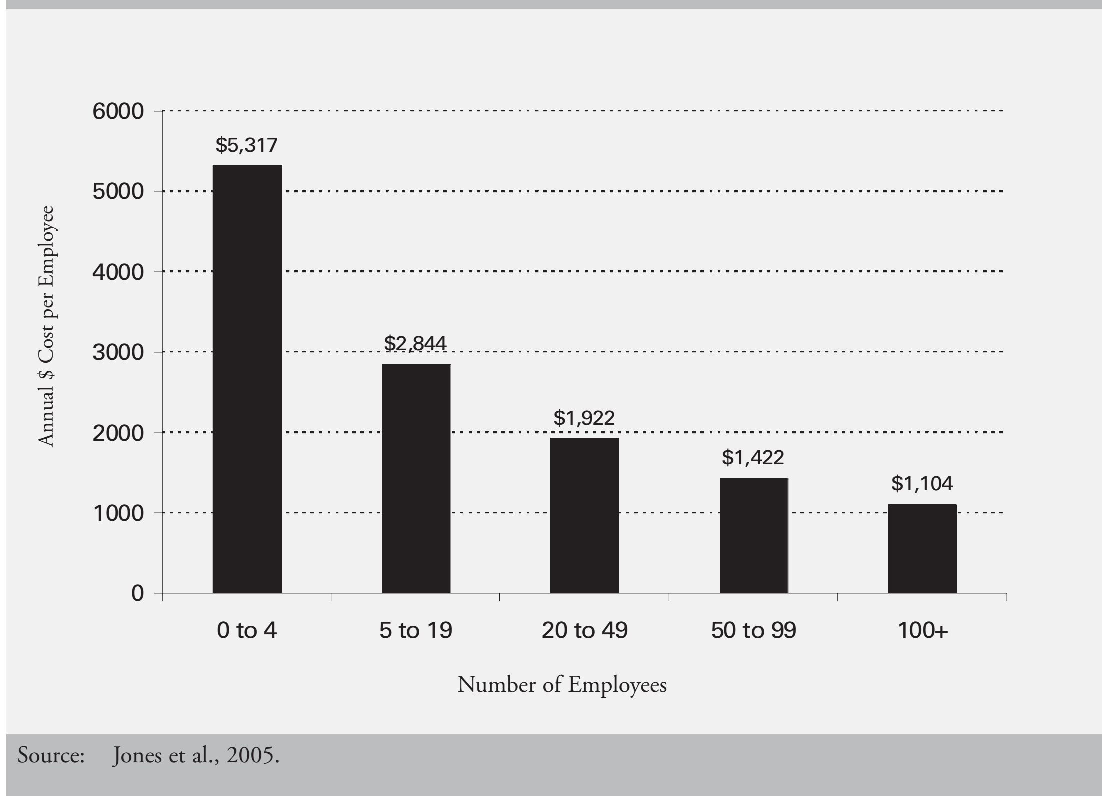
According to several surveys of small businesses (CGAC 2006 and CCR 2002), the regulatory challenge is not over-regulation so much as it is the complexity of the regulatory system itself. Correspondingly, there are continuing efforts at all levels of government to simplify the regulatory system in order to reduce the costs of compliance.[13]

There are, however, a few specific regulations that may be directly affecting small business growth and, thus, the prospects of small businesses owners and their workers. For example, there are labour as well as health and safety regulations that

12 There was, previously, a $2-million limit on both the amount of the original investment and on the amount that could be reinvested in shares of eligible small business corporations. These limits were eliminated in the 2003 federal budget.

13 The federal government and most provinces have begun developing their own plans for reducing the complexity of their regulatory systems.

Figure 5: Direct Compliance Cost of Regulations by Firm Size



Source: Jones et al., 2005.

apply only to larger businesses. This can influence a small business's production choices, which can affect its long-term viability as an employer. This section highlights some of these regulatory policies and their consequences.

Collective Dismissals

Employment protection laws exist to protect workers from arbitrary, unfair or discriminatory actions by their employers. Finding the right balance between labour market flexibility and job security can be difficult. These laws are important for ensuring the well-being of workers, but when they discourage growth, they are not always in workers' best interests. In Canada, employment protection laws exist primarily in the form of mandatory advanced notice of termination for both individual and collective dismissals. In the case of collective dismissals, extended periods of notice are compulsory, and sometimes consultations among the employer, employee representatives and government are required, as well as severance pay.

At the federal level, the Canada Labour Code defines a collective dismissal as the termination of 50 employees within a four-week period. For this to happen, the Minister of Labour must be notified 16 weeks before the first employee is dismissed. Severance pay is due to each affected employee – the greater of a week's wages or two days' wages for each year of work. The establishment of a joint planning committee to discuss alternatives to redundancy is also required.

All of the provinces, with the exception of Prince Edward Island, have collective dismissal laws, but the definition and details vary (Table 4). In Quebec, for example, the termination of 10 employees within an eight-week period counts as a collective dismissal, requiring eight weeks notice. The length of the notice increases as the number of employees to be terminated increases. For the dismissal of 50 or more employees, the

Table 4 Regulation

	Collective Dismissal Laws			Health and Safety Regulation		
	Number of Employees	Notice (Wks)	Details	Legislation	Regulation	Number of Employees
Federal	50+ (within four weeks)	16	The establishment of a joint planning committee is required to discuss alternatives	Canada Labour Code	Work Place Health and Safety Committee Policy Health and Safety Committee	20 300
Alberta	50+ (within four weeks)	4		Occupational Health & Safety Act	Joint Worksite Health and Safety Committee	Optional
British Columbia	50 – 100 101 – 300 301+ (within eight weeks)	8 12 16	The establishment of a joint planning committee may be required by the Minister to discuss alternatives	Workers Compensation Act	Joint Health and Safety Committee	20 for high hazard sectors 50 for low hazard sectors
Manitoba	50 – 100 101 – 300 301+ (within four weeks)	10 14 18	The establishment of a joint planning committee may be required by the Minister to discuss alternatives	Workplace Health and Safety Act	Joint Health and Safety Committee	20
New Brunswick	10+ representing at least 25% of employees (within four weeks)	6		Occupational Health & Safety Act	Joint Health and Safety Committee	20
Nfld. and Lab.	50 – 199 200 – 499 500+ (within 4 weeks)	8 12 16		Occupational Health & Safety Act	Occupational Health & Safety Committee	10
Nova Scotia	10 – 99 100 – 299 300+ (within 4 weeks)	8 12 16		Occupational Health & Safety Act	Joint Occupational Health and Safety Committee	20
Ontario	50 – 199 200 – 499 500+ (within 4 weeks)	8 12 16	Severance pay is due if the employee was employed for five years or more, the severance occurred because of a permanent discontinuance of the employer's business and the employee is one of 50 or more being dismissed within 24 weeks, or the employer has a payroll of $2.5 million or more.	Occupational Health & Safety Act	Joint Occupational Health and Safety Committee	20
P.E.I.	*Not specified*			Occupational Health & Safety Act	Joint Occupational Health and Safety Committee	20
Quebec	10 – 99 50 – 99 300+ (within 8 weeks)	8 12 16	The establishment of a joint planning committee is required upon request of the Minister where the number of employees dismissed is 50 or more.	An Act Respecting Occupational Health and Safety	Health and Safety Committee	20 (optional) Required upon written request of 10% of employees, or 4 if workforce is fewer than 40
Sask.	10 – 49 100 – 299 100+ (within 4 weeks)	4 8 12		Occupational Health & Safety Act	Occupational Health & Safety Committee	10

Sources for Collective Dismissal Legislation: federal and provincial labour codes and employment standards acts.
Source for Health and Safety Legislation: Federal Labour Code and provincial workplace health and safety acts.

establishment of a joint planning committee is required upon request of the Minister of Labour.[14]

Employment protection laws such as these can lead to a decline in productivity growth as firms choose to retain unproductive workers to avert the costs associated with collective dismissals. In addition, smaller firms, not yet subject to collective dismissal laws, may substitute capital for labour – moving away from the optimal capital-labour mix – in order to avoid hiring new employees and becoming subject to collective dismissal liabilities.[15]

Such strategies distort worker flows and production choices. They are also more likely to be undertaken by smaller businesses that have fewer employees and cannot bear the costs and risks associated with collective dismissals. In general, a slowdown in productivity growth resulting from regulation-induced labour market rigidities can affect small business growth (Autor, Kerr and Kugler 2007).

Furthermore, while there is some evidence that advanced notice laws have a positive effect on short-term employment, the effects are negligible in the long run. And there are few incremental gains to having mandatory notice periods much beyond one month (Kuhn 1993). In light of this, collective dismissals laws and the associated mandatory notice periods should be reviewed to ensure a balance between protecting the interests of workers and the promotion of growth.

Health and Safety Committees

The federal government and all provinces require that businesses establish health and safety committees to monitor work conditions and make recommendations for the improvement of workplace health and safety. This system was developed to give workers some control over their working conditions and to put the onus for compliance on co-operative action by workers' representatives and local managers rather than on government monitors (O'Grady 2000). All jurisdictions exempt small businesses from establishing health and safety committees. Most draw the cut-off line at 20 employees, although Newfoundland and Labrador and Saskatchewan use a 10-employee threshold (Table 4).

Several studies have found that health and safety committees are important for lowering worker injury rates (among them are Lewchuk, Robb and Walters 1996, and Havlovic 1991). Furthermore, health and safety committees are beneficial to employers in the long run as the costs associated with worker time lost due to injury and other legal costs are reduced in a safer work environment.

However, the initial implementation of health and safety committees can be costly for small businesses. The 20-employee threshold can become a significant hurdle for growing companies who must deal with the increased expense, often transmitted through higher prices, lower wages or reduced returns to shareholders. This then becomes another factor affecting a small business's decisions about expansion and growth.

Obligation to Re-Employ

One last threshold of note relates to legislation requiring businesses of a given size to re-employ injured workers who had been employed for at least a year prior to the worker's injury. In Newfoundland and Labrador, Ontario and Quebec, businesses with 20 or more employees are obligated to re-employ injured workers. This has the effect of reducing flexibility in the management of a company's labour force, and may discourage expansion beyond the 20-employee threshold.

Pro-Growth Policy Reform

The federal and provincial governments can take a number of steps to improve the growth potential of small businesses. Ironically, these steps involve eliminating and reviewing policies that were

14 Other provinces have a simpler definition of a collective dismissal, with no restrictions other than advanced notice. In Alberta, for example, a collective dismissal is defined as the firing of 50 or more employees within a four-week period. Four weeks notice is required.

15 It was mentioned earlier that capital deepening is important for firm growth. However, there is an optimal path for capital accumulation, and deviation from this path, such as a premature substitution of capital for labour, can be detrimental.

instituted to boost their growth prospects. Governments need to look at the thresholds created by preferential tax and regulatory treatment and find alternatives for those policies that deter and inhibit growth.

The following recommendations offer a guide for promoting small business growth in Canada.

Tax Reform

As a result of the number of preferential tax schemes for small businesses, making adjustments to all of them would represent a major overhaul of the corporate tax system. And although this may be necessary in the long term, the recommendations set out in this section address only the most pressing concerns. The tangled logic that is the small business tax system undermines the entrepreneurial spirit of Canadian business owners, rather than nurturing it. The guiding principle behind tax reform should be to remove policies that distort business decisions by creating incentives to remain small.

The small business deduction may be the most misguided of all the small business tax policies because it provides a financial incentive to restrict growth. Currently, the federal small business tax rate is 11 percent and the general federal corporate rate is set to fall from 19.5 percent to 15 percent in 2012. Instead of continuing to reduce both the small business rate and the general rate, while reducing the gap only slightly, we should introduced a flat tax of 13 percent for all businesses, regardless of size. What would be the result?

According to federal government estimates, the Small Business Deduction would cost $4.42 billion in 2008, based on a small business rate that is nine percentage points lower than the general rate.[16] In other words, the cost is roughly $490 million for each percentage point. A marginal increase in the small business rate to 13 percent from the current 11 percent would result, ceteris paribus, in an increase in government revenue of roughly $980 million per year.

We can also project the cost of a reduction in the general corporate rate to 13 percent from 15 percent. Ottawa has estimated the cost of a half-point reduction in the general business rate in 2011-2012 at $725 million,[17] which translates into an overall cost of $2.9 billion a year for a two percentage-point reduction.

Based on these back-of-the-envelope calculations, the cost of implementing a flat 13 percent corporate income tax would be roughly $1.92 billion ($2.9 billion minus $980 million). Of course, this rudimentary calculation does not take into account endogenous effects (i.e. the additional effects of a flat tax on business decisions and the overall economy), where in reality, the revenue loss would probably be lower due to the removal of the incentives to stay small.

Moreover, a 13 percent business flat tax would be more competitive internationally, counteracting profit shifting to low-tax jurisdictions (Mintz 2006). Smaller businesses would profit from a simpler tax system (one that no longer calls for complicated and expensive accounting and tax avoidance schemes) and a significantly lower tax rate on income above the old $400,000 threshold.

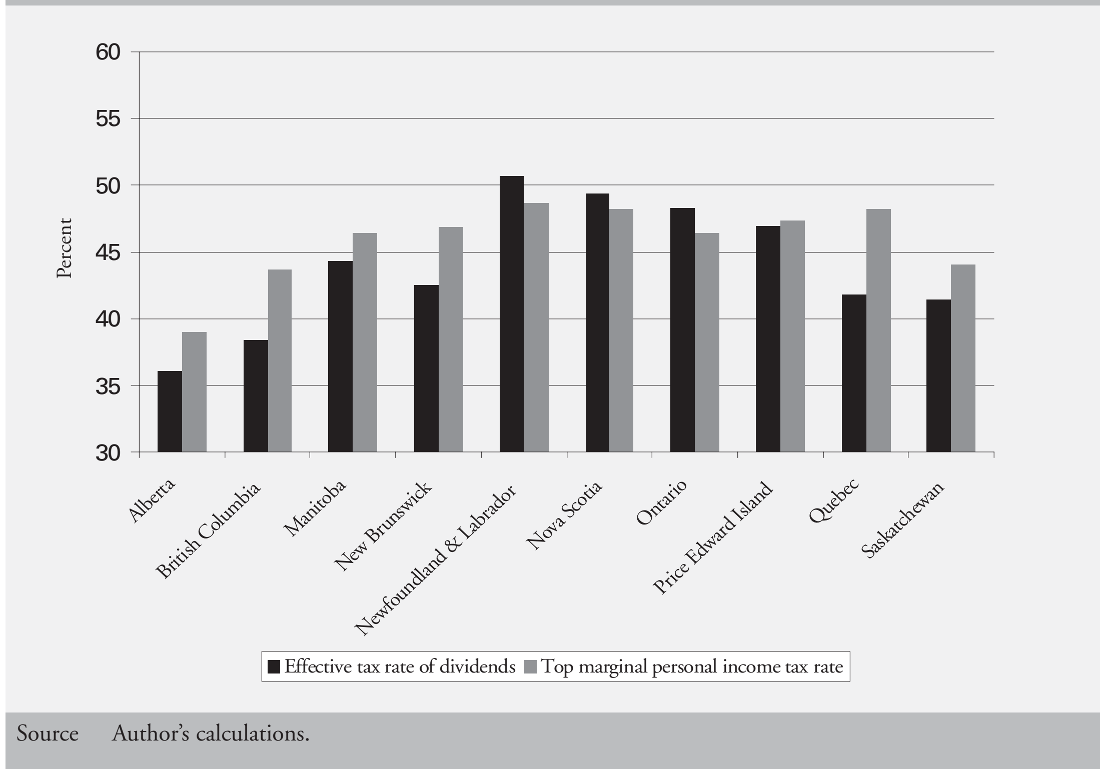
Such reform, in combination with the elimination of the federal and provincial capital taxes – a process that is underway in most provinces – would remove two significant barriers to growth. Moreover, with a 13 percent federal corporate income tax rate, corporate and personal income taxes would be relatively integrated for domestic investors, given today's provincial corporate income tax rates and the new dividend tax credit system (Figure 6).[18] The lower general rate would further reduce distortions as it would minimize the impact of double taxation of foreign investors who cannot take advantage of the dividend tax credit. In a small, open economy, such

16 See Tax Expenditures and Evaluation, Government of Canada (2006). These numbers were generated before the current accelerated plan for the reduction of the small business rate.

17 See Tax Fairness Plan, Government of Canada (2006).

18 Provinces could make further adjustments to their tax rates to achieve full integration. In its Economic Statement 2007, the federal government encouraged provinces to adopt a 10 percent corporate income tax rate in order to achieve an overall 25 percent corporate income tax rate.

Figure 6: Tax rates with proposed 13 percent federal corporate income tax (at top marginal personal income tax rates)



Source Author's calculations.

as Canada's, foreign investors are an important source of capital for businesses and should not be discouraged.

After removing these two deterrents to growth, it is important to look at improving growth facilitation by improving access to effective capital. A clarification and simplification of the capital gains rollover could help boost investment in small businesses. Moreover, extending the capital gains rollover to include corporate and other institutional investors would increase the amount of venture capital in the Canadian economy and help direct funds to the businesses with the greatest growth potential.

Regulatory Reform

Regulatory reform is a more difficult issue than tax reform. Whereas the existing tax policies described above were instituted to help small business owners, the regulatory policies were instituted to protect their employees. The compliance costs are considered a cost of doing business. However, regulation on collective dismissals and health and safety committees is too broad and does not take into account firm- and industry-specific characteristics. Developing smarter and more focused regulations could reduce their overall cost while maintaining the necessary worker protection standards.

For example, collective dismissal laws apply broadly to all businesses that have a certain number of employees. This means that large, established businesses are treated the same as smaller companies that might be considering taking on new projects and employees. Many large businesses are the primary employers in some communities and industries, and it is important that workers are protected from arbitrary or unfair collective dismissals. But smaller businesses that are looking to grow should not be discouraged from starting new ventures and taking on innovative projects that involve some risk. If collective dismissal laws were adjusted to focus primarily on large, established businesses, smaller businesses would be

free to grow and innovate without having to worry about collective dismissal liabilities.

One way to achieve this would be to follow New Brunswick's lead and define a collective dismissal as a percentage of a firm's overall workforce rather than a particular number. For example, defining a collective dismissal as the firing of 50 or more employees representing at least 10 percent of the total workforce within a given amount of time would ensure that the law applies only to larger businesses. For businesses with fewer than 500 employees, the guidelines for collective dismissals would be determined through negotiations between the employer and the worker's union, or other worker representatives.

Such a measure would give smaller business the flexibility to start new projects that involve some risk without being subject to mandated dismissal liabilities. This could spur short-term employment, and in the long run could lead to increased overall employment levels. It is also assumed that as firms approach the 500-employee mark, scale effects will make the threshold a much smaller obstacle and therefore will not be a significant factor in a business's production choices.

In the case of health and safety regulation, while it is difficult to compare costs and benefits of mandatory health and safety committees, it is clear that small businesses do incur substantial compliance costs. However, it should be noted that some activities undertaken by businesses are more dangerous than others, and it follows that enforcement efforts should be directed towards these activities and the industries in which they are undertaken. Smarter, more focused regulation of health and safety could go a long way in reducing unnecessary costs associated with the establishment of committees in businesses that provide low-risk environments – i.e. the work they do is inherently safe, or their system for managing the risk is inherently good.

Industry- or sector-specific regulation for health and safety committees would address this issue. For very low-risk industries, health and safety committees would be entirely voluntary; for medium-risk industries, health and safety committees would be mandatory, but their powers and functions would be limited and, finally, all high-risk businesses would be required to establish health and safety committees as they are currently mandated.

Conclusions

It is important that fundamental economic considerations, and not the tax and regulatory systems, are the guiding principles in investment and growth-related decisions. In creating parallel tax and regulatory systems for small businesses, the federal and provincial governments have contravened this principle – and the result is arguably a stifling of Canada's economic dynamism. Canada's tax and regulatory systems should be evaluated to ensure they are addressing market failures and not inducing economic distortions or encouraging small-business tax avoidance strategies.

The policy recommendations outlined here would go a long way to reducing the disincentives to growth that are now part of the small-business tax and regulatory environment. Reforming small business taxation would remove major incentives for firms to stay small and make the Canadian economy more competitive overall. On the regulatory side, efforts should be made to ensure that current policies – such as collective dismissal laws and mandatory health and safety committees – are not having a detrimental effect on labour flows, long-term employment and production choices. Finally, the recommended policies would have little effect on small businesses that are not looking to grow. Therefore, these proposals provide a balance between nurturing small business and encouraging growth and innovation.

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