

Small Business

... Supporting National Employment As Job Creation Slows

Mary Webb
mary_webb@scotiacapital.com

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Highlights

- *Small business (firms with less than 50 employees) is expected to underpin national employment as Canada experiences a period of slower job creation.*
- *The SARS outbreak and other unforeseen events have affected Canadian corporations of all sizes. Looking forward, however, small business has several advantages, including its orientation to comparatively more buoyant domestic markets that are less influenced by the higher Canadian dollar and international competition.*
- *Small business is benefitting from several years of federal and provincial tax cuts. Further assistance, in the form of graduated income tax rates as income rises, would help to smooth a smaller firm's transition to a larger operation.*

Current Labour Market Dynamics

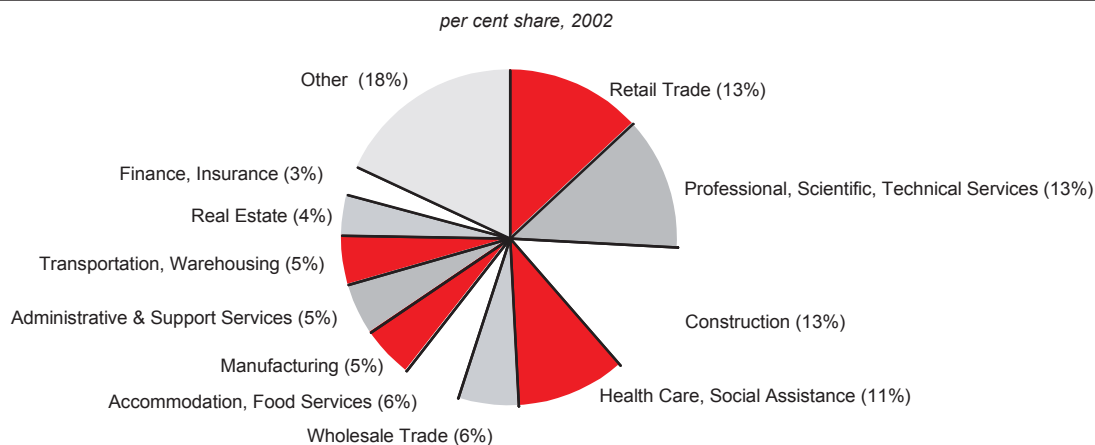
The robust job creation that distinguished the Canadian economy in 2002 has stalled. Employment gains on a year-over-year basis have slid from more than 3% in early 2003 to

1.3% in August. Since the beginning of 2003, the number of paid private-sector employees has slipped.

In response, small business's counter-cyclical role in labour markets is beginning to emerge. The number of self-employed has climbed 2.5% during the first eight months of 2003. Small business employment has successfully weathered this year's setbacks. As a major player in both the tourism and agri-food sectors, small business has been very sensitive to the fallout from SARS, the incident of mad cow disease and the subsequent string of negative events, including the recent East Coast damage from Hurricane Juan.

For the Canadian economy, these one-time events have exacerbated the weakness stemming from the slow global recovery, extended trade frictions, the Canadian dollar's sharp appreciation and increasing competition from the emerging economies in Asia. In this environment, Canada's larger corporations are particularly vulnerable as non-energy export receipts lose ground. In addition, low-priced imports to Canada have intensified competition in our domestic markets. With many corporations

Canadian Microbusiness* Employment by Industry



*Enterprises with less than five employees. Components do not sum to 100% because of rounding error.

unable to raise prices, cost controls to reinforce the bottom line are expected to constrain hiring by large companies into 2004. Although growth in the U.S. economy is now picking up, international competition is expected to remain intense for some time.

Small Business's Near-Term Edge

A survey of small- and mid-size enterprises (SMEs) in September¹ indicated that their expectations for the next year have largely rebounded from the dip in confidence reported in June. While there are still a number of factors squeezing smaller firms' margins, such as the rising cost and frequently the limited availability of insurance, the resilient outlook that has characterized small business over the past few years has resurfaced. Almost 30% of the September survey respondents planned to expand their full-time payrolls over the next year.

Several factors are playing into this positive outlook. Small business is involved directly and indirectly in the export of goods and services, but its exposure relative to larger corporations is much less. Moreover, small business activity in domestic markets is often in those areas that are least affected by low-priced imports. For the areas of domestic spending that bolstered small business confidence in 2001 and 2002, the outlook is still relatively upbeat. These sectors include the housing industry and its many local suppliers, infrastructure projects, real estate, health care, computer services and repair & maintenance. In the construction sector, for example, small business accounts for about two-thirds of employment.

A key beneficiary of current low interest rates is small business, and these low rates are now expected to extend through 2004. In fact, the Bank of Canada is expected to ease rates further this fall if the economy remains sluggish and the Canadian dollar continues to climb sharply higher. For small business, affordable borrowing costs will help to maintain momentum in household spending and housing activity. As well, much of small business financing is tied to shorter-term rates.

Small business is well-positioned, particularly with recent technological advances, to take advantage of larger corporations' restructuring. In addition to outsourcing opportunities, smaller firms have the flexibility to quickly capitalize on new trends. For many enterpris-

es, a pause in hiring by large corporations offers the possibility of gaining skilled employees. In recent years, SMEs have become increasingly concerned about shortages of qualified labour in some industries.

Regional Detail

In Atlantic Canada, small business this year has faced the cod fishery closure, reduced quotas for several other species and the damage from Hurricane Juan. Yet the sustained upward shift in the region's employment is supporting the services sector. Pockets of buoyant small business activity include transportation and warehousing in Nova Scotia, health care and social assistance in New Brunswick, and a variety of household services in Newfoundland and Labrador and Prince Edward Island.

In Quebec, growth in construction and social services such as daycare have fuelled small business job creation in recent years. Both areas should benefit from the new provincial government's commitment to affordable housing and a sustainable framework for daycare.

The performance of many of Ontario's small businesses this year has been dampened by one-time events such as the SARS outbreak. Yet specialized skills and entrepreneurship continue to support small business expansion in a number of industries such as professional and technical services. By mid-2003, for example, the number of high-tech firms in the Ottawa region reached a new record, even though employment remained soft from downsizing by the larger players. Small business in Ontario will also continue to be supported by the high level of immigration to the province — it is the home for over half of the international immigrants arriving in Canada during the 1990s.

Momentum in Manitoba's and Saskatchewan's small business sector is being maintained by the services sector, particularly health care and other social services. Health care, with the aging of the baby boom generation, stands out as an area of significant opportunity for small business.

Small business in Alberta is thriving, partly because its strong population growth is a basic driver for business start-ups. Smaller firms are also prominent in the scientific and technical services required by the oil & natural gas industry. As well, the provincial economy's rapid

expansion has spurred small business employment in construction, retail trade and administrative and support services.

British Columbia continues to boast the largest share of small enterprise employment among the provinces. Its small business sector, however, has had to grapple with extensive forest fires this summer, on top of employment declines in the forestry sector. Preparations for the 2010 Olympics are expected to be positive for small business, not only with respect to the substantial construction required, but also in areas such as retail trade, entertainment and recreation where smaller firms have already posted sizeable gains.

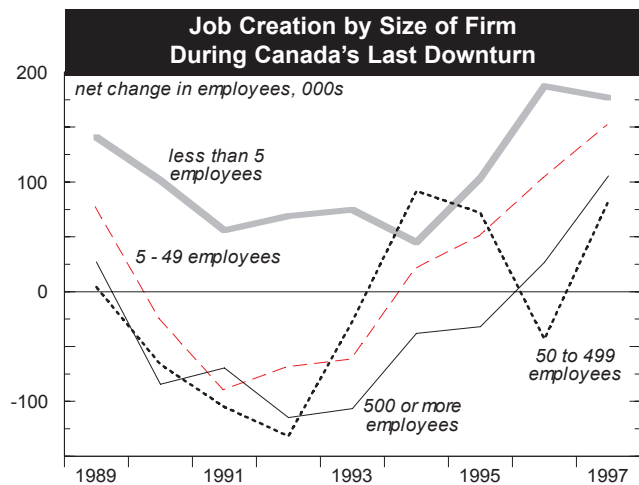
Small Business Job Creation During the Early 1990s

The counter-cyclical role of small business, with its large component of self-employment, is evident in past downturns. In the early 1990s, even when key areas of domestic demand such as housing were contracting, employment by small business was resilient². From 1990 to 1993 when private-sector payrolls were shrinking, microbusinesses (enterprises with less than five employees) continued to hire.

Among the larger players of the small business sector — those with five to 49 staff — job losses were just three-quarters of the employment declines recorded for mid-sized enterprises with 50 to 499 employees. In addition, sustainable employment growth resumed among the bigger small businesses more quickly than it did among larger firms.

In contrast, the biggest corporations reported the most striking employment declines from 1990 to 1993. The net decrease in their work force outpaced the job losses in mid-sized firms by close to 15%. As well, these large corporations continued to shed jobs through 1994 and 1995, and did not provide a substantial number of new positions until 1997.

Small business support for Canadian household incomes, however, does not match its employment boost. Last year, the average weekly earnings of employees in small businesses were still three-quarters of the wages paid by corporations with 300 or more employees. A significant gap in benefits and bonuses also exists, though this typically narrows during a slow-down.



Source: Statistics Canada, *Employment Dynamics*.

Government Support for Small Business

Going forward, small business faces a more encouraging tax environment. Employment Insurance premiums are being scaled back, albeit slowly, and increases in Canada Pension Plan premiums for the foreseeable future were completed in January 2003.

Among the provinces, trimming taxes for small business has proven to be a relatively effective and low-cost route for stimulating growth. The western provinces, Ontario and New Brunswick have progressively trimmed their small business corporate income tax (CIT) rates. New Brunswick now boasts a provincial small business CIT rate of just 3.0% and Alberta is expected to match New Brunswick's rate in April 2004. By 2005, seven of the ten provinces are expected to have a small business CIT rate of 5.0% or less.

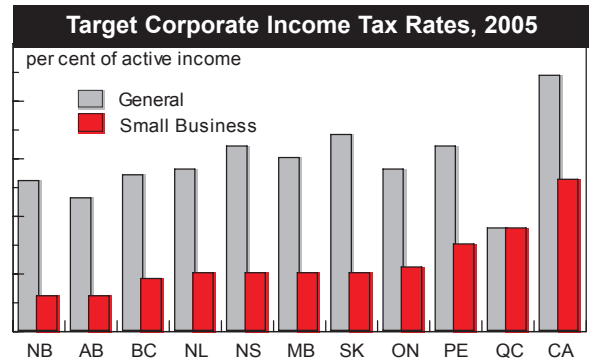
Also important are the efforts by Ottawa and most of the provinces to expand the small business CIT category as small business income continues to advance. The ceiling defining small business is rising from \$200,000 of active business income to a target of \$400,000 — a level that is already in place in New Brunswick and Alberta. In addition, a number of provinces have broadened their exemption for other levies, such as payroll or capital taxes.

As venture capital financing and IPO activity declined with the extended slump in equity markets, Ottawa and the provinces have introduced a number of measures to make investing in small businesses more attractive. At

the federal level, the guidelines for tax-free rollovers of small business investment have been widened. The provinces have focussed on enhancing small business investor tax credits.

A continuing concern, however, is the jump in the CIT rate and other taxes as a small business expands. The transition from a small- to a mid-size enterprise is generally challenging, and typically involves a number of new risks, such as venturing outside of established markets. Canada's growth and productivity would both benefit if more small enterprises could evolve to larger operations.

At the federal level, the gap between the small business and the general CIT rate is currently nine percentage points, and it is almost as wide or wider in every province except Quebec. The latter is unique with one CIT rate for all sizes of business, a policy that currently favours its larger corporations.



An alternative to the current two-rate system is a series of graduated CIT rates for an expanding firm. The revenue cost of such a measure would be moderate relative to other proposed tax cuts. As small business helps to carry Canada through a period of slower employment growth, encouraging an even greater contribution from this sector represents an important opportunity.

¹ Canadian Federation of Independent Business.

² Data for 1989 to 1997 are from Statistics Canada's *Employment Dynamics*. Data include incorporated and unincorporated enterprises issuing T4 slips. To estimate private sector activity, health & social service, education and government service industries are excluded.

	Average Annual Rate on Active Business Income				Ceiling (July 1)	
	1998	2000	2003	2004f	2003	2004f
	per cent				\$000 of active income	
Federal ¹	13.12	13.12	13.12	13.12	225	250
Newfoundland & Labrador ¹	5.00	5.00	5.00	5.00	225	250
Prince Edward Island	7.50	7.50	7.50	7.50	200	200
Nova Scotia ¹	5.00	5.00	5.00	5.00	225	250
New Brunswick	7.00	4.50	3.00	3.00	400	400
Quebec ²	5.91	9.01	8.94	8.90	-	-
Ontario ³	9.17	7.33	5.50	5.50	320	320
Manitoba ¹	9.00	7.00	5.00	5.00	320	360
Saskatchewan ⁴	8.00	8.00	6.00	5.50	300	300
Alberta ⁵	6.00	6.00	4.13	3.25	400	400
British Columbia	9.00	4.75	4.50	4.50	300	300

¹ Includes surtax of 1.12 percentage points for 1996-2005. Federal rate of 22.12% applies for active income between \$225,000 and \$300,00 in 2003. Ottawa, Newfoundland and Labrador and Nova Scotia are raising their small business ceilings from \$200,000 in 2002 to \$300,000 in 2006 in \$25,000 increments. Manitoba is raising its ceiling from \$320,000 in 2003 to \$400,000 in 2005 in \$40,000 increments.

² Includes Anti-Poverty Surtax of 2.8% from November 1996 to November 1999 and Youth Fund surtax of 1.6% from March 2000 to March 2003. Quebec has one CIT rate for all sizes of businesses.

³ Ontario's small business CIT rate was scheduled to fall to 4.0% by 2005, with the ceiling rising to \$400,000 and the phase-out range extended to \$1 million. The new government plans to freeze the small business CIT rate at the 2003 level.

⁴ Rate scheduled to drop to 5% for 2005.

⁵ Revenues permitting, rate scheduled to drop from 4.0% to 3.0% on April 1, 2004.

Source: Federal and Provincial Budgets.