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Entrepreneurial Finance and Economic Growth: A Canadian Overview

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Abstract

Equity capital plays an important and growing role in connecting financial resources to investment opportunities in a highly productive manner. Exchange-listed companies, IPOs, venture capital and private equity are all complementary investment avenues. Each plays a vital role that allows companies more efficient access to capital for improving productivity, boosting long-term growth and innovation, and creating better jobs. On this dimension, Canada enjoys an enviable position. Despite these positive factors, Canada's ranking compared to that of other major economies on key dimensions of competitiveness and drivers of sustainable economic growth has been declining. In 2009-10, Canada ranked ninth on the Global Competitiveness Index; in 2018, it had fallen to twelfth place. More worrisome for the future is that Canada's lacklustre performance in areas known to be significant contributors to productivity, competitiveness and sustainable growth is pervasive across industries and regions. Although the Canadian financial industry cannot be held responsible for all the shortcomings in Canada's performance, there is no escaping that a disconnect seems to exist between the generally favourable assessment of the effectiveness and strength of the Canadian financial industry and the overall competitiveness of the Canadian economy in the short and long run. One potential explanation has to do with the median size of exits in Canada, which is almost an order of magnitude smaller than in the United States. Moreover, institutional equity investors often engage in sales to foreign firms rather than IPOs. One powerful disincentive to exit through public markets is federal government tax policies that discriminate against and penalize Canadian innovative and high-growth companies that "go public." In addition to correcting these counterproductive biases, serious consideration should be given to adopting a tax measure similar to the US Small Business Jobs Act of 2010, which provides for full exemption from federal taxation of capital gains realized on the sale of the shares of certain small businesses. There is empirical evidence that the exemption has had a significantly positive effect in the US. Serious consideration should also be given to reducing the capital gains tax on shares issued by qualified SMEs when they list on a Canadian stock exchange and are held by individual investors for a reasonable period of time, since evidence suggests that capital gains taxes influence the underpricing of IPOs. The adoption of such a tax measure applicable to exits by an IPO or upon listing the shares on a Canadian stock exchange would help establish a more neutral playground for the choice of exits, which, to a large extent, is the crux of the matter.

Keywords: Financial Services and Regulation; Capital Markets; Corporate Governance

JEL Classification: G32; G28; O16


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