COVID-19 Policy Brief

CAPITAL IS KEY

FINANCING ENTREPRENEURSHIP IN ONTARIO AFTER COVID-19

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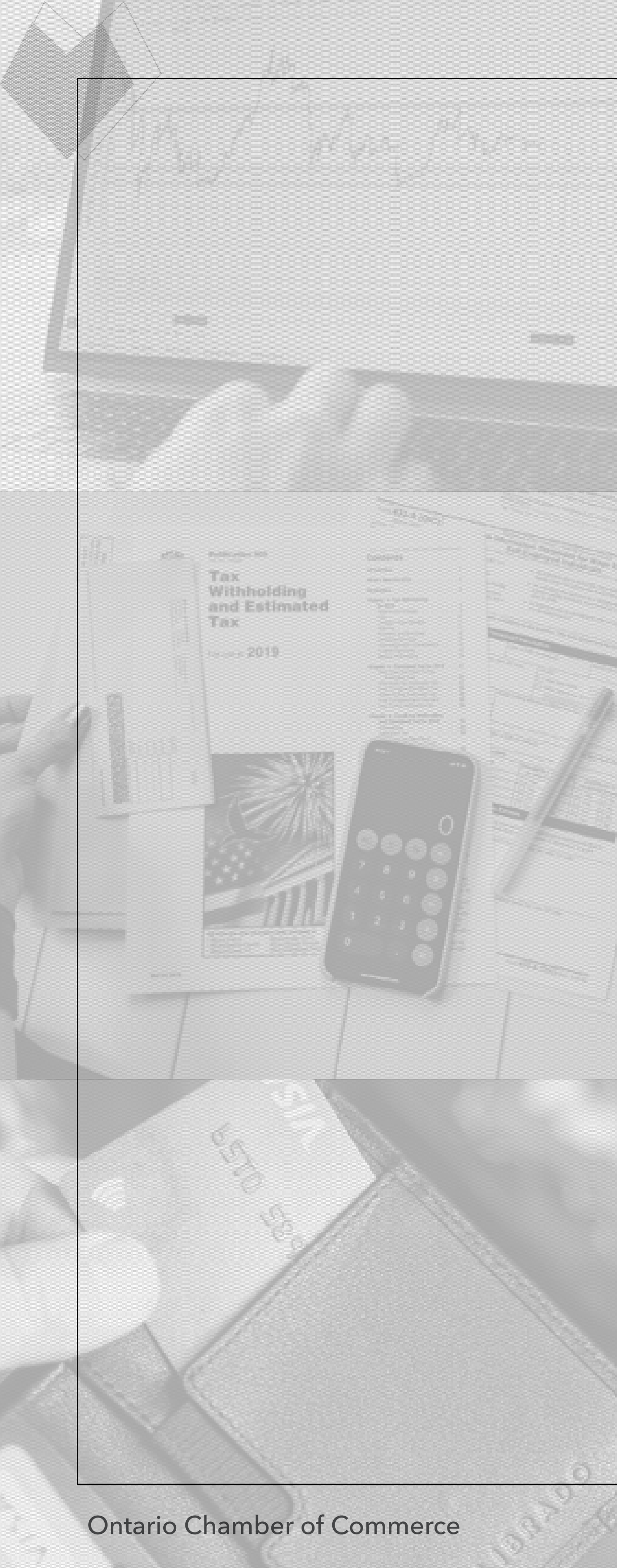

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Executive Summary

Ontario's small business owners are armed with grit and creativity, which proved instrumental as they adapted to public health restrictions throughout the COVID-19 pandemic. However, managing cash flows and debt became a challenge as the crisis forced many businesses to suspend, adapt, or restructure their operations. Meanwhile, as the pandemic accelerated digital transformations, many of Ontario's innovation-oriented firms flourished.

Looking ahead, entrepreneurship will be fundamental to Ontario's economic recovery and it will require access to the right forms of capital. Recognizing that newer and smaller businesses are inherently riskier to finance, Ontario must develop policies to bridge gaps for entrepreneurs who will be in greatest need of support as they rebuild and grow in a post-pandemic world. This means enhancing access to capital for firms that were less well-financed before the crisis, as well as high-growth firms with the potential to drive long-term competitiveness.

Summary of Recommendations

In this policy brief, the Ontario Chamber of Commerce (OCC) offers the following policy recommendations to the Government of Ontario:

1. Perform cost-benefit analyses of all existing and new small business financing programs to advance evidence-based policy decisions.
2. Implement a targeted loan guarantee program in partnership with financial institutions to help entrepreneurs rebound after COVID-19.
3. Pilot a tax credit program that incentivizes private investments in small businesses.
4. Improve access to public procurement opportunities for small businesses by addressing administrative, financial, and information barriers.
5. Implement recommendations in the 2021 Capital Markets Modernization Taskforce Report to help small businesses access a broader range of investors.
6. Build on existing efforts to create a regulatory sandbox that allows for controlled experimentation with small business financing.
7. Develop a pathway to permanent residency for international graduates interested in purchasing shares or ownership of existing small businesses.
8. Create a one-stop information portal for small business support programs.
9. Work with financial institutions to streamline application processes for business supports and continue using digital tools to improve access.

This brief also explores the following policy recommendations to the Government of Canada:

1. Perform cost-benefit analyses for all existing and new small business financing programs to advance evidence-based policy decisions.
2. Modify the Highly Affected Sectors Credit Availability Program to include a forgivable loan option.
3. Increase the lifetime capital gains exemption limit on qualified small business corporate shares.
4. Provide additional liquidity to asset-based finance lenders by launching a securitization program through the Business Development Bank of Canada.
5. Make child care an eligible business tax deduction.

Glossary

Angel investor: high-wealth individual that use their own money to invest directly in early-stage start-ups or founders.

Asset-based financing (ABF): financing of specific assets, such as vehicles or equipment, usually through a lease, loan, or line of credit. Providers of ABF include banks, credit unions, insurance companies, government agencies, the finance affiliates of manufacturers, and independent finance companies and vendors.[i]

Capital: the financial assets (including debt, equity, and working capital) that enable businesses to invest in their own day-to-day operations and growth.

Crowdfunding: the practice of funding a venture by raising money from a large number of people, typically via the internet.

Debt financing: includes lines of credit, equipment loans, cash flow loans, mortgages, and other forms of debt.

Equity financing: the process of raising capital through the sale of shares, either through public or private equity markets. Public equity investors are paid through stock accumulation, while private equity investors are paid through distributions.

Financial Services Regulatory Authority of Ontario (FSRA): an independent regulatory agency that regulates activities of the insurance industry, credit unions and caisses populaires, mortgage brokers, and pension plan administrators in Ontario.

Government financing: grants, subsidies, and non-repayable contributions offered by government and usually targeted towards specific sectors or business activities, such as digitization.

Intangible assets: assets that are not physical in nature. Examples include data, patents, brands, and knowledge.

Loan guarantee: loan program through which a third party will assume a portion of debt obligations for lenders in case of borrower default.

Ontario Securities Commission: an independent Crown corporation that oversees Ontario's capital market participants, including reporting issuers, investment industry intermediaries, and market infrastructure entities. The Innovation Office was established in 2020 to foster and test innovative business models and methods in capital formation, transaction, and service efficiency and fairness.

Private equity: capital invested in a company or other entity that is not publicly listed or traded.

PropTech (property technology): start-ups offering innovative products or new business models for the real estate markets.

Public equity: financing generated from selling a company to the public.

Quasi-equity: combines elements of debt financing and equity financing. With flexible repayment terms, and costs tied to performance, this option is often appropriate for growing businesses without sufficient assets for collateral or a long history of profitability.

Scale-up firm: small, innovative firms that are growing at a rate of at least 20 percent per year.[ii]

Small business: a business with 1 to 99 employees. Medium-sized businesses are businesses with 100 to 499 employees, and large businesses are businesses with 500 employees or more.

Trade credit financing: a product or service on credit provided by a supplier and pay that supplier at a later date.

Venture capital: investments in early-stage businesses deemed to have strong growth potential.

Working capital: the amount of cash and other assets a business has available after all its current liabilities are accounted for. Working capital is an indication of a firm's short-term liquidity (its ability to pay its bills as they come due).[iii]

PART I:

ENTREPRENEURSHIP PRE- AND POST-COVID-19

Entrepreneurship is often characterized as an engine of the economy. Small businesses (defined as firms with fewer than 100 employees) account for 66 percent of all jobs in Canada,[iv] and there is copious research linking strong entrepreneurial ecosystems to job growth and economic development.[v] When small businesses do well, they reinvest in their communities, grow the tax base, create jobs, and add character to local downtowns.

COVID-19 has put significant parts of this engine in jeopardy, and jumpstarting it will require improved access to the right forms of capital. According to a survey by the Ontario Chamber of Commerce (OCC), 60 percent of Ontario businesses are confident that entrepreneurship will bounce back after the pandemic.[vi] Facilitating that rebound will be one of the biggest feats of economic recovery.

Ontario's (Pre-Pandemic) Financing Landscape

The ability to start and grow a small business hinges on access to affordable capital. Pre-pandemic, Canada's small business financing landscape was strong.[vii] The average interest rate charged to small businesses in 2018 was 5.7 percent and the business risk premium was at its lowest level since the Great Recession (2.1 percent), reflecting an easing in access to capital.[viii]

Small businesses often carry a higher risk for lenders and investors because of low survival rates and insufficient information. Nonetheless, they have a rich landscape of options at their disposal in Ontario.

Figure 1: Financing of SMEs in Ontario[ix]

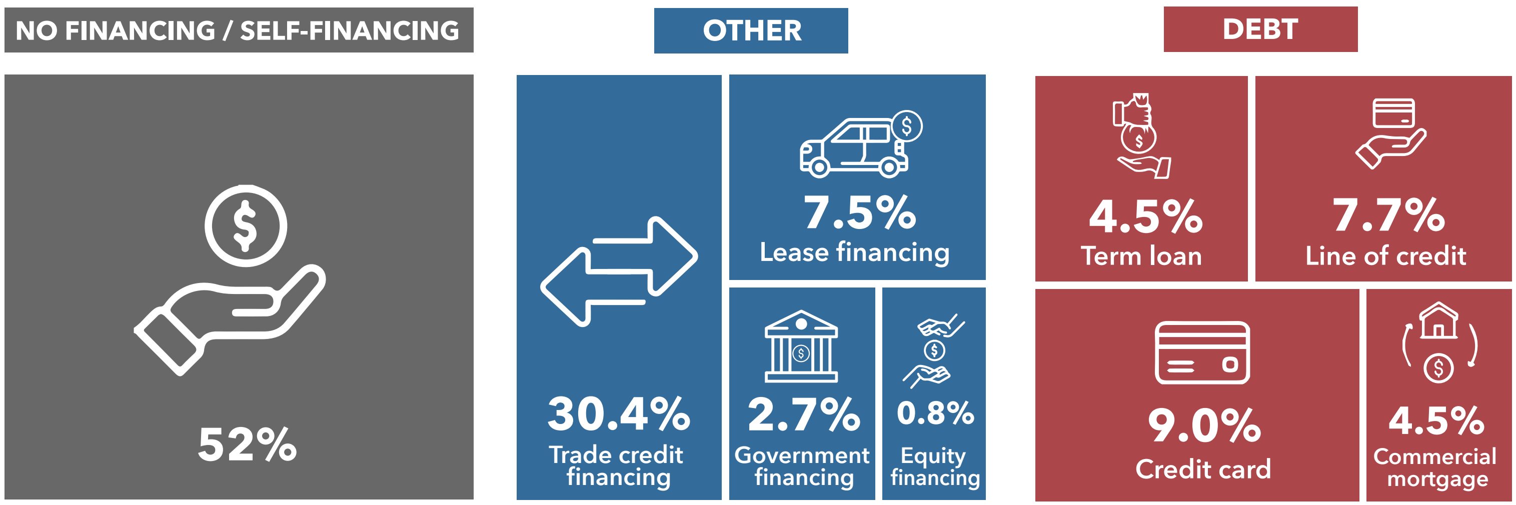

Figure 1 illustrates the most common sources of capital for small and medium-sized enterprises (SMEs).[1] In 2017, 48 percent of Ontario's SMEs requested external financing. Self-financing or financing through personal networks is a common approach for many entrepreneurs in the initial stages of their business. Twenty-four percent of Ontario SMEs sought debt financing. Others accessed trade credit, leasing, and equity financing. Smaller businesses were more likely to obtain financing from credit unions, while larger businesses were more likely to borrow from chartered banks.

Firms with rapid growth rates (known as scale-ups) often rely on an ecosystem of angel investors, accelerators and incubators, venture capital, and private equity to support their growth. These firms are often looking to compete at a global level, and their unique needs often benefit from the advice and connections offered by experienced investors.

1 This data includes medium-sized businesses (100 to 499 employees) in addition to small businesses (1 to 99 employees), which skews the results more towards external financing.

Alternative financing mechanisms are also available to scale-up firms that cannot (or prefer not to) rely on debt. For example, quasi-equity or cash-flow-based lending relies on information about a company's revenue prospects, allowing borrowers to overcome the collateral requirements involved in regular lending.[x]

Though most financing is provided through the market, there are also various government-funded programs offered to Ontario's small business owners. Several noteworthy examples are listed in the Appendix. Many of these programs are oversubscribed, a testament to the high demand for financing support.

Pre-pandemic trends in small business financing included: growth in angel investments and venture capital funding, increased use of alternative instruments such as asset-based financing and online crowdfunding, and the implementation of digital tools to help small business owners access supports tailored to their needs.[xi]

Growth and Trends in Venture Capital, Angel Investments, and Asset-Based Finance

Venture Capital

Canada's venture capital industry has grown impressively over the past decade. In 2013, the Government of Canada launched a Venture Capital Action Plan with an investment of $400 million over the next decade to attract new venture capital from private investors. This was followed by the Venture Capital Catalyst Initiative in 2017, further leveraging private sector funds-of-funds to channel late-stage capital towards Canadian entrepreneurs. Canada's Budget 2021 proposes to invest up to $450 million over five years to renew the Initiative.[xii]

Support from the federal government has helped the industry flourish. From 2013 to 2019, annual venture capital investments increased threefold from $1.9 billion to $6.2 billion. Today, Canada ranks third for venture capital investments among members of the Organisation for Economic Co-operation and Development (OECD), behind Israel and the United States.[xiii]

In 2020, Ontario's information, communications, and technology (ICT) sectors accounted for 58 percent of venture capital deals in the province, followed by life sciences (17 percent) and agribusiness (4 percent).[xiv] Toronto led the pack among Canadian cities, with $1.27 billion in venture capital invested over 164 deals in 2020.[xv]

Angel Investors

Angel investments have helped catapult many of Ontario's successful enterprises. In addition to capital, angel investors offer business advice, networks, and other forms of support, particularly at the early stages of a firm's growth. Often, they are motivated to support their local communities, in addition to making a direct return on investment.

Canada's angel investment community has grown steadily in recent years. In fact, the Northern Ontario Angels (NOA) is the largest network of its kind in North America by dollars and deals.[xvi] Since NOA's inception in 2009, its investors have signed 357 deals with 110 investors, creating 3,555 new jobs. Forty-eight percent of those deals were in the technology industry, 22 percent in manufacturing, 18 percent in services, five percent in resources, four percent in real estate, and two percent in entertainment.[xvii]

Asset-Based Financing (ABF)

In 2019, $440 billion in assets were financed through Canada's ABF sector ($180 billion in Ontario).[xviii] This volume of financing activity has generated an estimated $85 billion in economic activity (3.7 percent of Canada's GDP), largely from the productivity enhancements that come with investing in equipment.[xix] The growth of ABF has served as an important complement to traditional lending. Since ABF deals are approved based on cash flows rather than customers' net worth, they allow businesses to procure vehicles or equipment without using up their regular credit.[xx] Further, 90-day loan delinquency rates for small- and medium-sized businesses are lower for ABF than other forms of financing.[xxi]

COVID-19 and Access to Capital

Unlike the financial crisis of 2007-08, financial markets have not been the primary casualties of the COVID-19 pandemic, and access to capital has remained relatively stable in Canada.

Nonetheless, many businesses found themselves in a cash flow crisis as restrictions on non-essential businesses led to lower revenues and higher costs. Larger businesses were not immune, but smaller firms generally have less room to maneuver on their balance sheets. In 2020, between February and September, 25,614 businesses closed in Ontario, and many others continue to struggle with the economic hardships brought on by COVID-19.[xxii]

Most emergency support programs rolled out by governments were loan programs. A portion of these loans were forgivable, but they still added to the debt burden of businesses. By November 2020, 43 percent of small businesses in the province said they could not afford to take on additional debt.[xxiii]

Sectors with the steepest dips in their revenues include: food and accommodations; arts, entertainment, and recreation; and retail. The pandemic also had disproportionate impacts on businesses owned by women, racialized Ontarians, Indigenous people, and recent immigrants.[xxiv] This is partly because these entrepreneurs are overrepresented in sectors that were hardest-hit by COVID-19, and partly because they were more predisposed to pre-pandemic financing barriers. Certain businesses also found themselves ineligible for government programs under their initial designs.[2]

In contrast, some sectors have experienced record growth rates. Ontario's innovative technology companies were on a strong trajectory pre-pandemic, with Toronto ranked as North America's fastest-growing market for technology jobs.[xxv] As COVID-19 generated unprecedented demand for their goods and services, it also nudged investors to channel more capital towards them. Venture capital investments in Canada totaled $4.4 billion across 509 deals in 2020 – the second-highest level on record – with 80 percent of investments going towards firms in the ICT and life science sectors.[xxvi]

On the supply side, lending conditions tightened slightly.[xxvii] Default rates increased, and fixed assets often used as collateral (such as commercial real estate and hotel properties) became inherently riskier. However, this too varied by sector. On the one hand, new lending *increased* in the first half of 2020 for the primary, construction, manufacturing, and professional, scientific, and technical services. On the other hand, lending *decreased* for the wholesale and retail trade, and accommodation and food services sectors.[xxviii]

Overall, financial markets remained stable and capital markets rebounded after a steep drop in the first two months of the pandemic. This is both a testament to the resilience of Canada's financial system and a result of government's ability to anticipate a potential liquidity crisis with a combination of fiscal, monetary, and regulatory measures designed to ensure capital would continue flowing.[xxix]

2 For example, businesses without staff on payroll (i.e., self-employed entrepreneurs that rely on independent contractors) did not qualify for many federal supports, and tourism sector businesses were not eligible for the Ontario Small Business Support Grant.

Specifically, the Bank of Canada reduced the policy interest rate from 1.75 percent to 0.25 percent in March 2020 and swiftly launched asset purchase programs to increase liquidity in core markets. The Office of the Superintendent of Financial Institutions lowered the domestic stability buffer and used other instruments to make more funds available for lending. Financial institutions played a critical role as well, working with small businesses on a case-by-case basis to accommodate their needs.

Meanwhile, over the course of the year, the Governments of Ontario and Canada each introduced a series of financial relief programs to support small businesses (see Appendix). Many of these supports were flexible and open-ended. Others were strategically targeted towards pandemic-related expenditures such as rent, personal protective equipment, and digitization costs.

These measures – coupled with the inherent stability of Canada's financial system – have helped many small businesses across Ontario pivot and confront the crisis. The pandemic has also displaced many workers who, instead of looking for a new job, may be interested in shifting their careers to start their own businesses.

Top Challenges

Although Ontario's entrepreneurs have access to relatively good financing options, there are eight key challenges.

1. **RISKY BUSINESS**: Small businesses (particularly start-ups) are generally riskier to finance than larger ones because they have shorter credit histories, fewer assets, and lower survival rates. Lenders tend to mitigate these risks by charging higher interest rates, offering lower loan amounts, and/or requiring more collateral to cover potential losses. In Canada, the interest rate spread between small and large businesses is larger than in most other OECD countries (206 basis points in 2018).[xxx] Further, the smaller a firm, the more likely it is to have its loan application rejected.[xxxi]

2. **SCALE-UP FIRMS**: Although Ontario excels at producing start-ups, it has been less successful at turning high-growth firms into global competitors.[xxxii] This is often partly attributed to a shortage of patient growth capital willing to take on the risks associated with innovative firms. Additionally, many of these firms derive their value from intangible assets such as data, which typically cannot be used as collateral.[xxxiii]

   This leads many promising scale-ups to seek financing abroad, often selling majority stakes to investors before reaching their full potential.[xxxiv] In fact, Canadian firms tend to have smaller exit values than US firms.[xxxv] That gap is expected to narrow over time as our venture capital industry matures and the federal government continues to target programs towards scale-ups through its Innovation and Skills Plan.[xxxvi]

3. **DIVERSITY:** Barriers to accessing capital are uneven across demographic groups, which limits opportunities for some entrepreneurs and undermines broader social and economic outcomes. For a closer look, see 'The Diversity Deficit' (next page).

4. **DEBT**: Despite relatively low interest rates, debt is not always the right solution for small businesses, particularly those with less collateral and/or irregular cash flows. Loans often require personal guarantees, and not all entrepreneurs have sufficient assets to provide as collateral.[xxxvii] Combined with higher pricing, this can make loans unattainable or unattractive for many founders. The pandemic has amplified these challenges, leading more Ontario businesses to say they cannot afford to take on more debt.[xxxviii]

5. **WORKING CAPITAL**: Over the past decade, Canadian businesses have signaled a growing need for external capital to cover day-to-day operating expenses.[xxxix] Working capital is especially important for start-up firms that may lack adequate cash flows to reinvest in their businesses in the first several months. However, in Canada, most government-supported loans and grants are designed for other uses, such as technology adoption. According to the Government of Canada's own analysis, "Almost all G7 countries, with the exception of Canada, offer additional debt-financing products, such as lines of credit in addition to term loans, with a view to better assist SMEs with their day-to-day expenses."[xl3]

6. **INDUSTRY BIAS**: Private equity and venture capital investors tend to have more appetite for sectors that are considered knowledge-intensive, such as information technology and biotechnology.[xli] As a result, more traditional brick-and-mortar businesses (such as restaurants and retail stores) may have limited access to equity investments. This may prove to be a greater challenge after the pandemic, as these sectors will need significant capital to bounce back.

7. **PANDEMIC PRESSURES**: As temporary grant and loan programs expire, many small businesses will need access to new financing or refinancing to grow, restructure, or simply keep their doors open. Taxes and fees that were deferred temporarily during the crisis will come due, credit losses will remain elevated, and financiers will in turn take a relatively more conservative approach to risk. This will make it especially challenge for small businesses and start-ups with riskier profiles.[xlii]

8. **SUCCESSION**: Ontario's aging population has implications for small business succession. By 2030, the number of seniors aged 65 and over is projected to almost double to 23 percent of Ontario's population.[xliii] The growth in the share and number of seniors accelerates over the 2019–2031 period as baby boomers turn age 65. As this transition unfolds, entrepreneurs will need financing to take over for retiring business owners. This is a challenge but also an opportunity for the next generation.

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3 This is why, in Budget 2021, the federal government has proposed enhancing the Canada Small Business Financing Program with a new line of credit product to help with liquidity and cover short-term working capital needs.

The Diversity Deficit

Although financing challenges are ubiquitous for small businesses, women and visible minority founders are even more likely to report difficulties with managing cash flows and obtaining new financing.[xliv]

For women-owned businesses, this is partly because of differences in the ways their enterprises tend to be structured (i.e., smaller and less likely to be incorporated) and the industries in which they are more concentrated (i.e., the service and social enterprise sectors, and less in the technology sector).[xlv] Women may have different styles of pitching and seek lower levels of funding than men, but there is also research showing that investors may be biased towards pitches from men even when the same content is pitched by women.[xlvi] The result is that women are more likely to rely on self-financing; in Canada, women raise just four percent of venture capital funding, despite accounting for 28 percent of entrepreneurs. [xlvii]

Indigenous entrepreneurs also report lower levels of external financing. This is partly due to the *Indian Act*, which prohibits reserve lands from being used as collateral for a business loan. It also reflects geographic constraints and higher interest rates charged to Indigenous-owned businesses.[xlviii] [xlix] In a recent survey, only 19 percent of Indigenous entrepreneurs in Canada say they accessed business loans or lines of credit from financial institutions to start their businesses (compared to more than 30 percent of all start-ups).[l] [li] Aboriginal financial institutions and Community Futures offices have helped fill some of these gaps in Ontario, but demand outpaces supply.

Lower levels of external financing are similarly seen among immigrant entrepreneurs, although their requests are just as likely to be approved as Canadian-born entrepreneurs when they do apply.[lii] Lower-income and younger entrepreneurs also tend to have fewer personal assets they can use as collateral.

Addressing these inequities is critical for both social and economic reasons. When entrepreneurs from diverse backgrounds succeed, not only do *they* benefit, but consumers gain more innovation in the products and services offered to them.

In April 2021, the Brookfield Institute for Innovation + Entrepreneurship released a toolkit to help funders reduce biases and increase access to capital for underrepresented entrepreneurs throughout the funding process.[liii] The Government of Canada also invests in several programs aimed at supporting women, Indigenous, and Black entrepreneurs (see Appendix), and Budget 2021 proposes a series of new measures to expand that support. This includes additional funding to strengthen the Women Entrepreneurship Strategy and Black Entrepreneurship Program, a new Inclusive Growth Stream for the Venture Capital Catalyst Initiative, and legislative amendments to expand the types of revenues that First Nations may use to support borrowing from the First Nations Finance Authority.[liv]

CASE STUDY:

Innovate Cities: Supporting SME Growth through CityScape, an Innovation Marketplace for the PropTech Sector

Although Canada excels at producing start-ups, it has been less successful at helping small businesses turn into high-growth, globally competitive firms. **Innovate Cities**, Canada's only government-sanctioned not-for-profit smart cities organization, is a network of innovators focused on creating more inclusive, livable, and sustainable cities. It was founded to drive Canadian smart city innovation and commercialization by providing SMEs with the building blocks they need to connect, create, and scale.

Innovate Cities firmly believes that access to capital is a key component for companies' economic growth. For this reason, Innovate Cities is developing **CityScape** in partnership with the Toronto Region Board of Trade. CityScape is an innovation marketplace that allows technology start-ups and small businesses to connect with potential clients from the real estate sector (i.e. major tenants, commercial property owners, and service providers) interested in implementing smart city technologies to improve the urban experience of individuals who use their spaces. CityScape is a one-stop-shop intended to facilitate and streamline the procurement and deployment process for PropTech (technology for the real estate industry).

This digital marketplace is valuable for both buyers and sellers. Canadian technology scale-ups would gain greater exposure to customers and purchase orders. And since the ability to raise capital from investors is directly tied to revenue streams, access to the marketplace could lead to growth in institutional investments as well. Moreover, the marketplace would also supply innovators with professional services, including marketing and intellectual property services, thus allowing technology vendors to cut costs in these areas.

From a buyer's perspective, the marketplace would de-risk the procurement process. Specifically, CityScape would address two of the greatest uncertainties on the road to technology adoption: whether the technology works and whether the integration process of the technology will be too slow and complex. First, the offerings found in the marketplace will be vetted by an expert advisory team, guaranteeing that all the offerings do as they promise. Second, the marketplace would incorporate radical transparency into its operations; buyers will be given the opportunity to rate the products, provide feedback, and write reviews to create a "word-of-mouth" mechanism in the marketplace, where credibility is built and trust is earned.

CityScape is aligned with Innovate Cities' values and commitment to maintaining individuals' privacy. Privacy-by-Design principles will be integrated into the marketplace operation and all its offerings to protect the privacy of Canadians. Additionally, the marketplace would incorporate **CityShield** – the Innovate Cities Data Trust – where data would be securely shared between innovators to provide them with the information they need in order to improve their products, thus creating a virtuous cycle.

Innovate Cities.

PART II:
THE REBOUND

Good financing will be necessary for the recovery of Ontario's small businesses and the broader economy. In a survey of OCC members conducted in the fall of 2020, access to capital was identified as the top policy priority for businesses across sectors, ownership structures, and years of operation.[lv]

Capital is no silver bullet. For example, businesses looking to adopt digital solutions will also benefit from advisory services that expand on the success of the Digital Main Street Program, especially in retail and other sectors where customers have become accustomed to online shopping.

However, the remainder of this brief will focus on financing. Below are a few effective policy options that can be implemented immediately. As decision-makers approach this challenge, we encourage them to evaluate the costs and benefits of different programs, consider whether the solution can be targeted towards specific types of businesses or entrepreneurs, and work with businesses to ensure programs are easy to access.

The Governments of Ontario and Canada should perform cost-benefit analyses for all existing and new small business financing programs to advance evidence-based policy decisions.

Loan Guarantee

Loan guarantees are increasingly being implemented by governments around the world to enhance access to capital for small businesses and other under-financed segments of the economy. Through a loan guarantee, lenders are able to offer funding with lower collateral requirements. They are easy to administer because they make use of existing relationships between businesses and lenders. Although a grant can achieve a similar purpose, the loan guarantee is cheaper and thus allows government to reach many more businesses more efficiently. Various government loan guarantees already exist in Canada, including the Canada Small Business Financing Program (CSBFP) – which is fully cost-recoverable[lvi] – and the Highly Affected Sectors Credit Availability Program (HASCAP) (see Appendix). However, there is room for growth here, as Canada's loan guarantees for small businesses represent the second-lowest level of support among G7 countries in both absolute dollars and relative to GDP after the United Kingdom.[lvii] Further, there are no loan guarantees specifically aimed at supporting new start-ups and the expansion of small businesses in Ontario during economic recovery.

Nova Scotia implemented a provincial loan guarantee in 2003, which began modestly as a $3 million pilot. Thanks to a low default rate (less than 4 percent since inception), the initial capital and subsequent contributions have blossomed into a $144 million portfolio. This portfolio has financed 2,486 small businesses that, in turn, have created 16,000 jobs, many in rural communities. The program is delivered in partnership with credit unions and includes other forms of support, such as business coaching. It also has special financing streams for immigrant entrepreneurs, social enterprises, forestry, and other sectors.

In Ontario, a loan guarantee program could be targeted towards costs associated with starting new ventures, such as equipment, franchise fees, real estate, and marketing. Further, it can be offered strategically to specific market segments that tend to be less well-financed through the market (such as women and Indigenous founders), as well as sectors that experienced high levels of business closures during the pandemic (such as restaurants, tourism businesses, and some retail).

A variable debt product, such as a line of credit, should be added to help finance short-term working capital requirements. For example, the United States offers revolving lines of credit under its Small Business Administration CAPLine program, with four options to help businesses meet their cyclical and short-term working capital needs.[lviii]

Credit unions would play a critical role in administering this program. Located throughout the province, credit unions have trusted relationships with many small businesses and a unique understanding of local economic needs. Following Nova Scotia's example, the program could be paired with access to business coaching and advisory services by small business advisors within financial institutions and Small Business Enterprise Centres across Ontario. Additionally, government should work with lenders to ensure products are priced competitively.

The cost to government would be minimal. Assuming a similar scale and default rate as Nova Scotia's program, Ontario's loan portfolio would be $2.9 billion over the next 18 years, reaching nearly 50,000 small businesses at an annual cost to government of approximately $6.4 million.[4]

Finally, government may consider complementing aspects of the federal Canada Emergency Business Account (CEBA). Specifically, a portion of the guaranteed loan could be forgivable if repaid by a certain date, otherwise, the remaining balance would be converted to a term loan.

> The Government of Ontario should implement a targeted loan guarantee program in partnership with financial institutions to help entrepreneurs rebound after COVID-19.

4 Ontario's economy is roughly 20 times the size of Nova Scotia's. A total loan portfolio of $144 million (in Nova Scotia), multiplied by 20, is equivalent to $2.9 billion in Ontario. A loan default rate of 4 percent (total cost of $115 million), divided over 18 years, is approximately $6.4 million.

Tax Incentives

In parallel, the Ontario government can consider incentivizing more private investments in small businesses. Program design can take several forms. For example, New Brunswick's Small Business Investor Tax Credit (SBITC) offers a tax credit to both individuals and corporations/trusts who invest in small businesses within the province.[lix] This includes:

- ◊ For individual investors, a 50 percent non-refundable personal income tax credit (of up to $125,000 per year), for investments of up to $250,000 in eligible small businesses and/or community economic development corporations or associations in the province.
- ◊ For corporations and trusts, a 15 percent non-refundable corporate income tax credit (of up to $75,000 per year), for investments of up to $500 in eligible small businesses in the province.

A different example is the Rural Investment Tax Credit (RITC) model, which has had success in various regions of the United States. Through this program, investment funds raise capital from private sources to invest in rural SMEs. If the funds achieve a predetermined return, their investors receive tax credits from the government.[5]

There is mixed evidence on the effectiveness of small business investment tax credits. Critics argue these programs can compensate investors for decisions they would have otherwise made and/or complicate Canada's tax system. That said, the RITC model has proven successful in the United States, where a similar program has generated $8 in private sector activity for every $1 invested by government in tax credits.[lx]

5 This approach differs from the Regional Opportunities Investment Tax Credit announced in March 2020, which offers a tax credit directly to businesses for capital investments they make in select regions of the province (see Appendix).

A tax incentive would be more impactful if targeted towards small businesses that have more difficulty accessing traditional financing. However, extensive eligibility requirements should be avoided as they would make administration of the program more complex and expensive.

The Government of Ontario should pilot a tax credit program that incentivizes private investments in small businesses.

Purchase Orders

For many local businesses, the best way for government to support their long-term growth and competitiveness is not financing, but rather, access to procurement. Historically, public purchase orders have been critical to giving start-ups access to the markets and revenues needed to scale (look no further than the US federal government's long relationship with Silicon Valley).[lxi]

In Ontario, small businesses have limited opportunities in public procurement due to a combination of financial and administrative barriers, poor contract transparency, and lack of scale.[lxii] Several governments have recognized the value in addressing these barriers. For example, the Government of New South Wales, Australia, instituted an SME Policy Framework as part of its wider procurement reform.[lxiii] Among other things, this framework required procuring agencies to take preventative measures to reduce financial burdens on SMEs that wish to make a bid.[lxiv]

Entrepreneurs with access to government contracts are far more likely to secure financing and benefit from tax incentives by virtue of the increased demand for their products and services. As the Government of Ontario proceeds with its procurement reforms, it should learn from other jurisdictions that have successfully used purchase orders to help local small businesses scale.

The Government of Ontario should improve access to public procurement opportunities for small businesses by addressing administrative, financial, and information barriers.

Capital Market Modernization

Small businesses are typically limited in their ability to raise funds from public equity markets. This is in part because the regulatory reporting requirements and costs can be overly onerous (including the underwriting, legal, accounting, and various other costs associated with filing an initial public offering). As a result, smaller firms tend to rely more on private markets, which retail investors have difficulty accessing.

The Capital Markets Modernization Taskforce Report released in January 2021 offers several specific recommendations to mitigate these challenges in Ontario.[lxv] For example:

◊ Reduce the regulatory burden on small public companies by allowing them to provide semi-annual reporting instead of quarterly reporting.

◊ Introduce a retail investment fund structure that adopts best practices from private equity investing to expand retail investors' access to small and early-stage businesses.

◊ Implement an alternative offering model to exempt reporting issuers from filing a prospectus. This would apply to securities listed on an exchange that are in full compliance with their continuous disclosure requirements, subject to certain conditions.

The Government of Ontario should implement recommendations in the 2021 Capital Markets Modernization Taskforce Report to help small businesses access a broader range of investors.[lxvi]

Regulatory Sandbox

The diversity of small businesses and their needs requires an array of solutions. One way to enable this is through a regulatory sandbox that allows for experimentation between businesses looking for capital and those looking to provide it.[lxvii] Sandboxes give financial providers (including fintech firms) a controlled environment in which to test innovative financing solutions with some reprieve from the usual regulatory constraints, while still under the supervision of regulators.

For entrepreneurs, a sandbox could mean access to more flexible debt and equity financing arrangements tailored to their unique needs, complementing what is available through traditional channels. Similar approaches have been implemented in around 50 countries following the United Kingdom's lead, with evidence that the approach has improved access to financing.[lxviii]

An Ontario Regulatory Sandbox should be undertaken by the Ontario Securities Commission's new Innovation Office and the Financial Services Regulatory Authority of Ontario (FSRA), both of which regulate different aspects of Ontario's financial services sector.[lxix] If successful, this model could be expanded into a Canadian sandbox to catalyze innovation at the national level.[lxx]

The recently passed, but not yet proclaimed, *Credit Union and Caisses Populaires Act*, 2020, gives the FSRA certain exemptive powers needed to allow credit unions to experiment with flexible debt and equity financing. The parameters for these sandboxes are yet to be determined, but they hold great promise as a catalyst to innovation in the Ontario credit union sector.

The Government of Ontario should build on existing efforts to create an Ontario Regulatory Sandbox that allows for controlled experimentation with small business financing.

International Graduates

Ontario's immigrant community is highly enterprising. Many international students at our post-secondary institutions are looking for opportunities to start a business and settle permanently within the province. In addition to their intellectual assets, these students often bring capital with them in the form of foreign direct investment.

This capital is largely an untapped source for Canadian small businesses. It is also an opportunity for Ontario to transition successful businesses into capable hands as our population ages.

To that end, Alberta and Nova Scotia have developed International Graduate Entrepreneur Immigration programs, through which eligible international graduates from post-secondary institutions can apply for permanent residence if they operate a local business. Ontario should consider a similar program, which could focus on matching entrepreneurial graduates with retiring business owners to help address financing challenges around succession and/or with small businesses looking for equity investment partners.

> The Government of Ontario should develop a pathway to permanent residency for international graduates interested in purchasing shares or ownership of existing small businesses.

Communication & Coordination

Small business owners rarely have the time to sort through scattered information about the many financing programs available to them. This limits the uptake of existing programs. For example, the Government of Canada's own research found that only 10 percent of small businesses are aware of the CSBFP.[lxxi]

During the pandemic, governments did a good job of collating information about support programs, presenting it on a simple one-stop website, and promoting the platform to businesses. This approach should serve as a model going forward, particularly as many existing and prospective business owners will be looking for specific types of financing to support rebuilding.

As a first step, we recommend developing an easy-to-use small business portal with information about relevant government-funded programs, similar to the federal government's Canada Business App.[lxxii] Ideally, this platform would be integrated with other services over time, such as a concierge window for small businesses and help with grant/loan applications.

However, another significant challenge for small business owners is the administrative burden associated with many government programs, many of which involve separate and/or duplicative application processes. Financial institutions can be reluctant to offer government-run programs because of the paperwork and compliance burdens required of them and their clients. Therefore, in addition to establishing an information portal, it is important to harmonize application processes and better integrate them with the systems already used by financial institutions.

According to the OCC's 2020 Small Business Friendliness Indicator, small businesses are embracing digital government and would benefit from a modernized, client-centric relationship with government.[lxxiii] The Government of Ontario is working towards a Digital Identity strategy, to be implemented by the end of 2021, which will allow business owners to open accounts, submit information, and register for permits and licenses online.[lxxiv] If integrated with federal government services – as done in Alberta and British Columbia – businesses will be able to use their digital identity seamlessly across governments.

Government can further modernize access to programs by implementing artificial intelligence into application processes. This would integrate information more efficiently, such that businesses applying to one program are automatically considered for others relevant to their needs.

The Government of Ontario should create a one-stop information portal for small business support programs.

The Government of Ontario should work with financial institutions to streamline application processes for business supports and continue using digital tools to improve access.

Federal Solutions

The federal government plays an important role in facilitating access to capital for businesses across Canada (see Appendix). While the bulk of this brief focuses on provincial solutions, the following table highlights policy options available to the federal government.

Federal Recommendation	Comments
Modify the Highly Affected Sectors Credit Availability Program (HASCAP) to include a forgivable loan option.	The HASCAP is appropriately targeted towards the hardest-hit sectors. However, mounting debt is not a feasible solution for businesses that are already overleveraged. A forgivable loan option would work better to support the hardest-hit business.
Increase the lifetime capital gains exemption (LCGE) limit on qualified small business corporate shares.	The LCGE allows small businesses to avoid paying taxes on capital gains income up to a certain amount when they sell shares in the business, a farm property, or a fishing property. An increase in the LCGE limit would make it more financially attractive for small business owners to transfer ownership and generate new economic activity.
Provide additional liquidity to asset-based finance (ABF) lenders by launching a securitization program through the Business Development Bank of Canada (BDC).[lxxv]	The Canadian Secured Credit Facility was introduced in response to the 2008 financial crisis to enable the BDC to temporarily inject liquidity into the ABF sector. A similar approach could be taken following this crisis. If so, the BDC should provide ABF lenders with loan guarantees and competitive terms consistent with what other lenders receive.
Make child care an eligible business tax deduction.[lxxvi]	Accessing affordable child care is a pervasive barrier for women entrepreneurs.[lxxvii] Currently, business owners can write off a series of other expenses, including golf memberships and meals, but not child care.

LOOKING AHEAD

The COVID-19 crisis has had catastrophic impacts on Ontario's businesses and residents, particularly the hardest-hit sectors and demographics.

Yet there is reason for optimism. Economic projections for 2021 suggest moderate growth in employment and gross domestic product (GDP) leading to a near-full recovery in most regions.[lxxviii] The fundamentals of our economy are strong: financial markets have remained stable, the household savings rate has increased, and consumer confidence has rebounded.[lxxix] [lxxx] The resilience and entrepreneurial spirit displayed by Ontarians will continue to be an asset during economic recovery.

For these reasons, Ontario's small business community is expected to bounce back. Government's role should be to accelerate this process, not by competing with the investment market but by supplementing it with targeted incentives and investments. This brief offers policy recommendations at the provincial and federal levels to improve access to capital for small businesses and entrepreneurs with the aim of supporting economic growth and long-term prosperity. These are only one part of the solution; other forms of business support will be necessary, such as workforce development initiatives and expanding broadband access. Ultimately, productive partnerships between government and the private sector will allow Ontario's small business community to emerge stronger than ever.

Appendix: Liquidity Support Programs for Small Businesses in Ontario

Small businesses can take advantage of government-sponsored grants, loans, and tax incentives to support their liquidity needs. Prior to the pandemic, these included:

- ◊ **Canada Small Business Financing Program (CSBFP)**: a loan guarantee program that helps small businesses finance real property, equipment, and leasehold improvements, with risk shared between the Government of Canada and financial institutions. The CSBFP is accessible across Canada to small businesses in all sectors except agriculture.[lxxxi] Canada's 2021 Budget proposes several amendments to expand loan class eligibility, increase the maximum loan amount, expand borrower eligibility to include non-profit and charitable social enterprises, and introduce a new line of credit product to help with liquidity and cover short-term working capital needs.[lxxxii]
- ◊ **Business Development Bank of Canada (BDC)**: various programs including Small Business Loans, Venture Capital, Intellectual Property-Backed Financing, and more. BDC offers specific financing programs for Indigenous and women entrepreneurs. In addition, the BDC has committed to a lending target of $1.4 billion for women-owned businesses over three years.[lxxxiii]
- ◊ **Export Development Canada (EDC)**: Buyer Financing, Direct Lending, Purchase Order Financing, and more.
- ◊ **Regional Development Agencies**: a suite of federally funded programs focused on investing in and supporting businesses at various stages of development, including high-growth firms, to accelerate their growth and enhance their productivity.
- ◊ **Community Futures Loans**: loans for small businesses, funded by the Government of Canada and delivered by Community Futures Development Corporations (CFDCs).
- ◊ **Women Entrepreneurship Fund**: a Government of Canada program for women entrepreneurs and business owners.
- ◊ **Black Entrepreneurship Loan Fund**: a Government of Canada program for Black entrepreneurs and business owners.
- ◊ **Aboriginal Financial Institutions (AFIs)**: autonomous, Indigenous-controlled, community-based financial organizations that support First Nations, Métis, and Inuit businesses with business loans, non-repayable contributions, and other services. Most AFIs are capitalized by the federal government.
- ◊ **Venture Capital Catalyst Initiative**: a federal program launched in 2017 to increase access to venture capital for entrepreneurs and innovative businesses across Canada.
- ◊ **Futurpreneur Loans**: collateral-free loans for entrepreneurs aged 18 to 39, delivered by Futurpreneur Canada and BDC.
- ◊ **SmartSeed Seed Fund**: support for young start-ups based in Southern Ontario, offered by FedDev Ontario via Ontario Centres of Excellence.

- ◊ **CanExport Small and Medium-sized Enterprises**: grants to cover international market development activities, funded by the Government of Canada.
- ◊ **FedDev Ontario Business Scale-up and Productivity Program**: loans to support adoption and commercialization of technology for firms in Southern Ontario.
- ◊ **Industrial Research Assistance Program**: funding to support innovative, early-stage companies, offered by the Government of Canada via National Resource Council of Canada.
- ◊ **Strategic Innovation Fund**: late-stage growth capital in the form of repayable and non-repayable contributions to help Canadian firms across all industrial and technology sectors scale up and go global. The program is federally funded.
- ◊ **Canadian Business Growth Fund**: long-term minority capital to fund growth and expansion of mid-market businesses, offered by banks and insurance companies.
- ◊ **Lifetime Capital Gains Exemption**: federal tax program that allows small businesses to avoid paying taxes on capital gains income up to a certain amount when they sell shares in the business, a farm property or a fishing property.
- ◊ **Small Business Deduction**: tax program that reduces corporate income tax for all small Canadian-owned businesses. Effective January 2020, Ontario reduced its small business tax rate to 3.2 percent.
- ◊ **Scientific Research and Experimental Development (SR&ED) Program**: tax incentive for Canadian-owned businesses conducting R&D.
- ◊ **Commodity Loan Guarantee Program (CLGP)**: short-term operating loans for farmers for the purchase of crop input supplies. It is administered on behalf of the Ontario government by the Agricultural Credit Corporation.

Since the onset of the pandemic, federal and provincial governments have implemented a several programs to support businesses with liquidity challenges. Those accessible to small businesses include:

- ◊ **Canada Emergency Business Account (CEBA)**: interest-free loans to help businesses whose revenues have been affected by COVID-19, funded by the Government of Canada and delivered via EDC and financial institutions. The CEBA was the most popular program among small businesses, with 52 percent of small businesses in Ontario saying they received CEBA loans in the third quarter of 2020.[lxxxiv]
- ◊ **Business Credit Availability Program Guarantee**: to help SMEs cover payroll and operating costs, funded by the Government of Canada and delivered via EDC and financial institutions.
- ◊ **Co-Lending Program**: terms loans to help SMEs cover operational expenses, funded by the Government of Canada and delivered via BDC and financial institutions.

- ◊ **Regional Relief and Recovery Fund (RRRF)**: interest-free loans for SMEs whose business revenues have been affected by COVID-19, funded by the Government of Canada and delivered via CFDCs.
- ◊ **Canada Emergency Wage Subsidy (CEWS)**: Government of Canada subsidy to cover a portion of employee wages, for Canadian employers who experienced a drop in revenue due to COVID-19.
- ◊ **Canada Emergency Rent Subsidy (CERS)**: Government of Canada subsidy to cover a portion of commercial rent payments for employers who experienced a drop in revenue due to COVID-19.
- ◊ **Canada Emergency Commercial Rent Assistance (CECRA)**: rent assistance for small businesses, funded jointly by the Governments of Ontario and Canada.
- ◊ **Canada United Small Business Relief Fund**: grants to help small businesses offset the cost of expenses required to reopen safely or adopt digital technologies to move more of their business online, funded by the Royal Bank of Canada, the Government of Canada, and partners, and delivered via the Ontario Chamber of Commerce.
- ◊ **Digital Main Street Program**: support for small business digital transformation initiatives, funded by the Governments of Ontario and Canada.
- ◊ **Ontario Small Business Support Grant**: funding offered by the Government of Ontario to small businesses required to close or restrict services under lockdowns. An automatic top-up of the program was announced in Ontario's 2021 Budget.
- ◊ **Ontario Main Street Recovery Grant**: a grant from the Government of Ontario for small businesses in select sectors to help offset the costs of personal protective equipment.
- ◊ **Relief for Indigenous businesses**: interest-free loans and non-repayable contributions for Indigenous SMEs, funded by the Government of Canada and delivered via Aboriginal Financial Institutions.
- ◊ **Forest Sector Safety Measures Fund**: funding to help small- to medium-sized companies in the forest and wood products sectors with extra costs associated with implementing COVID-19 safety measures. Funding is provided by the federal government and delivered through the Ontario government.
- ◊ **Highly Affected Sectors Credit Availability Program (HASCAP)**: government-guaranteed financing for heavily impacted businesses and low-interest loans of up to $1 million over extended terms, up to ten years, offered by the Government of Canada.
- ◊ **Small Business and Entrepreneurship Development Program**: announced in Canada's 2021 Budget to support small business owners and underrepresented entrepreneurs, including youth, Indigenous people, persons with disabilities, LGBTQ2, Black and other racialized peoples, women, and other diverse entrepreneurs.

- ◊ **Regional Opportunities Investment Tax Credit**: a 10 percent refundable Corporate Income Tax credit offered by the Government of Ontario to support investment in regions where employment growth has been below the provincial average. The program incentivizes corporations to build, renovate, or purchase eligible commercial or industrial buildings in qualifying regions.
- ◊ **Sector-specific programs**: including Canada's Agriculture and Food Business Solutions Fund; Canadian Agricultural Partnership; Emergency Processing Fund; Agri-Food Supply Chain Sustainability Fund; Tourism Economic Development and Recovery Fund; Community Building Fund; and others, offered by the Governments of Ontario and Canada.
- ◊ **Tax relief measures**: including deferrals on tax filing and payment deadlines, a permanent increase in Ontario's Employer Health Tax exemption, postponement of Ontario's beer and wine tax increases, and more.

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