

**Financing the Gap:  
Small Capital and State Economic Development in Canada,  
1943-2005**

**Kimble F. Ainslie**

**The Copenhagen Institute**

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## Foreword

**Chresten Anderson, Chairman  
The Copenhagen Institute**

I am, of course, happy to introduce Kimble Ainslie's new book on small capital and state economic development in Canada, given his affiliation as Senior Fellow at The Copenhagen Institute.

Ainslie brings us a wonderfully detailed expose on how state politics works in Canada in relation to the small business sector as an agent of economic development. His thematic treatment is a lesson for the rest of us. For example, he argues that state developmental politics has been rife with dangerous currents: seven policy histories of riptides and undertows. Ainslie demonstrates just how difficult it is to progress beyond agenda setting phases, and to move into meaningful program administration to produce benefits for small firms. He describes how the national Governments in Ottawa has all too typically resorted to cruel acts of nondecision-making and symbolic politics against the small capital sector, quite literally for decades, while such Governments claimed small capital was the genesis of universally applauded employment creation. In a later chapter, Ainslie details how a massive and hugely expensive Canadian tax shelter scheme offered to a tax-burdened middle class was sold as generator of small business financing. Yet the sector lost out time again to state-sanctioned safe investments in larger medium-sized businesses and feckless community development, microenterprise and social economy projects.

This book, for me, underscores the precious insights of the Austrian school and others on the importance and need for a clear-sightedness on real entrepreneurship provided by Israel Kirzner and David Harper, and the work of our former colleague Don Lavoie at George Mason University. Ainslie penetrates the netherworld of state entrepreneurship, and identifies when and why it works, and when and why it can become a disaster. I also like Ainslie's treatment because he so trenchantly puts the lie to the current Marxist critique of neo-liberalism by David Harvey, and such Canadians as Leo Panitch.

While Europeans, Asians and even Americans may not be familiar with all the nuances of *Canadian* state capacity and state-business relations, they will surely benefit from the Ainslie's vivid descriptions and disciplined analysis, particularly his concluding chapter where he masterfully focusses on the central question: "why the state can or cannot succeed?" Again, neo-liberals and libertarians alike will appreciate how this political scientist analyzes the dimensions of state failure, why the state so frequently fails, and who is responsible. Indeed, Ainslie makes

plain why the state in Canada on small capital development is *big, strong and not very productive*. And, just in case we ever had become complacent about the representative quality of private business associations in talking to the state, Ainslie uncovers how and why the most prominent and expectedly professional associations stumble along the way and are too easily drawn into clientele relations.

Finally, Ainslie's *obiter dicta* at the end of his last chapter is a delight. He lets his hair down and meanders through the bad executive and administrative habits that Ottawa has taken up over too many decades. He offers a lucid overview of some practical antidotes to the bureaucratic disease to which Ottawa has fallen victim. His commentary is a useful lesson for executives and senior bureaucrats in European, Asian, and Latin American capitals and elsewhere.

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## Preface

The crash of national financial markets in Southeast Asia in 1997 and 1998 suggested to many neo-liberals including the *Wall Street Journal* and the *Economist* that the developmental state model had fallen into permanent disrepute at least as some sort of heuristic guidepost on economic growth and national development. The corruption of “crony capitalism” was thought to be the region’s principal undoing. To the extent that crony capitalism did undo these economies, our neo-liberal friends offered us a cautionary tale. But the thinking that suggests that mere crony capitalism has permanently undone the idea and practice of state developmentalism is wishful thinking of the highest order. State developmentalism in the guise of old mercantilism or in its more recent variations has been firmly entrenched in developing economies for centuries and will not be put asunder by periodic or even extended scandals among practitioners of corporate-state finance. An informed review of the American political economy, for example, a nation we typically think of as the hallmark of a weak state and effervescent free markets actually reveals a longstanding historical role for the state in the development of business enterprises – beginning in America’s colonial era and well before Alexander Hamilton’s initiatives on local economic development.<sup>1</sup> Indeed, it should be appreciated by observers that the numerous political economies of the American continents, Asia and Europe, whether they succeed or not, are properly understood by paying attention to state developmental plans and practices. As long as there are states like Canada with programs to expand and influence their private economies with economic growth designs, the developmental state will be active for good works or good’s undoing.

American political economist, Chalmers Johnson, popularized the concept of the developmental state in his study of the Japanese Ministry of International Trade and Industry. Since publication of his work in 1982, all manner of academic interest has been expressed about his formulation, including much criticism. Johnson expressed his core idea in the following terms: “the concept of the ‘developmental state’ means that each side [the state and business] uses the other in a mutually beneficial relationship to achieve developmental goals and enterprise

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<sup>1</sup> See Louis Hartz, *Economic Policy and Democratic Thought: Pennsylvania, 1776-1860*, Cambridge: Harvard University Press, 1948; Milton Heath, *Constructive Liberalism: The Role of the State in Economic Development in Georgia to 1860*, Cambridge: Harvard University Press, 1954; James Primm, *Economic Policy in the Development of a Western State: Missouri, 1820-1860*, Cambridge: Harvard University Press, 1954; Robert Parks, *Democracy’s Railroads: Public Enterprise in Jacksonian Michigan*, Port Washington: Kennikat Press, 1972; John A. Hall, *Liberalism: Politics, Ideology and the Market*, Chapel Hill: University of North Carolina Press, 1987, and James Alt and Kenneth Shepsle, ed., *Perspectives on Positive Political Economy*, Cambridge: Cambridge University Press, 1990.

viability.” Developmentalism is *state-led economic development*, as Johnson put it; it has involved state “intervention and protection” of business interests; it has been an empirically grounded “ideal” model of state performance and state-market relations. Properly functioning developmental states have putatively exhibited integrated structures of strong state action *and* pervasive private market decision-making.

Just as Andrew Shonfeld encouraged us four decades ago to inquire into the new balance between states and markets, it is time for some additional barefoot empiricism about Canada’s current state and market balance, as well as a thorough review on the capacities of the Canadian state to perform a constructive and enabling role in relation to the expansion and prosperity of Canada’s largest business sector, small capital.<sup>2</sup> Such a review also grants us the opportunity to gauge state economic development in a way that differs from past Canadian contributions by Larry Pratt, John Richards, Richard French, Michael Jenkin, and Donald Savoie.<sup>3</sup> In this book, I examine the successes and failures of Canada’s “developmental state” in relation to financing the nation’s small capital sector since World War II. I analyze these successes and failures through the lens of state performance and state-business participation at the national and provincial levels.

More particularly, this inquiry explores how the state treats a single policy problem, the “venture capital gap” for small capital. The venture capital gap has been described as that distance in formal and informal capital markets between the demand for equity or venture financing by entrepreneurs and proprietors and its supply by “angel” investors, corporate venture capitalists, merchant bankers, state programs and development banks, and other financial institutions.<sup>4</sup> While many suppliers of capital and some economists consider the gap to be merely

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<sup>2</sup> I use the term “small capital” to refer to small businesses having capital demands in the range of \$20,000-\$250,000 in the early 1950s and 1960s, and \$50,000 to \$500,000 in the 1970s to the 1990s. Small capital as a category is to be distinguished from “microenterprises,” which typically requires investments from \$500 to \$10,000 (in the 1990s). While many use the term “small and medium-sized enterprises,” in this study I emphatically distinguish medium-sized enterprises from small businesses, essential what I have termed small capital. Medium-sized enterprises usually solicit investments in the range of \$1-5 million (in the 1980s and 1990s). See the multiple references throughout this book.

<sup>3</sup> John Richards and Larry Pratt, *Prairie Capitalism: Power and Influence in the New West*, Toronto: McClelland and Stewart, 1979; Richard French, *How Ottawa Decides*, Toronto: James Lorimer & Co., Publishers, 1980; Michael Jenkin, *The Challenge of Diversity: Industrial Policy in the Canadian Federation*, Ottawa: Science Council of Canada, 1983; Donald Savoie, *Regional Development: Canada’s Search for Solutions*, 2<sup>nd</sup> Ed., Toronto: University of Toronto Press, 1992.

<sup>4</sup> “Angel” investors are informal venture capitalists that use their own funds for investments, compared to corporate venture capitalists that use “institutional” funds from pension funds, insurance companies, corporations or merchant banks. Angels are normally wealthy and previously successful entrepreneurs investing in emerging firms and entrepreneurs who are very or reasonably well known to the angel. Angel investors are said to provide “patient” capital, sometimes referred to as “love” capital. The Ontario Small Business Development Corporations program examined in chapter eight is a good example of state

apprehended, an anecdotal phenomenon, certainly not a sign of market failure, for most entrepreneurs and proprietors the gap is real enough. Entrepreneurs and proprietors typically observe from their experience that the gap has been entrenched, costly and vexatious for quite some time in Canada and elsewhere in the world.<sup>5</sup> It is the Canadian state response to this perceived venture capital gap and the chosen development paths taken up by state agencies that is the central inquiry of this study.

As noted, my analysis explores two dimensions of the developmental state and small capital: 1) the performance dimension: the capacity of state agencies and agents to respond to the venture capital gap for small capital, and 2) the participation dimension: relations between state and business interests on the small capital gap. State capacity is judged according to two conditions, that is: the presence of political legitimacy held by the state in relation to small capital, and the demonstrated competence of state agencies in the formation of small capital, including the specific competencies of executive political and senior bureaucratic state agents. State legitimacy is queried as a derivative of procedural or constituent (business) support, internal state authorization, and by the substantive legitimacy or inherently viable policy content the state seeks in order to authorize its actions. State competence is made evident in the appropriate crafting and execution of key tasks to formulate policies, design programs, and the proper carrying out of implementation activities. My approach to state performance is anchored in modernization theory and recent theoretical conceptualizations of legitimacy and competence. I also explore the salient determinants of these elements of state capacity in order to address the “why” question of state capital development success or failure. The second leading field of inquiry in this study is the nature of state-business relations for small capital development. At this intersection of interests, I investigate the structures of participation for small capital development; that is, how state actors, small business representatives, business associations, and other participants are linked, or not; what roles each set of interests adopts to accomplish its objectives, and the extent to which each actor or sector displays or is obstructed from displaying.

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financing of extant angel investors. By comparison, merchant banking refers to investment banking, where such institutions offer loans to firms and take equity positions.

<sup>5</sup> In Canada, the problem of the gap is thought to be particularly acute, because the Canadian chartered banks are so risk-averse, almost never taking equity positions in business enterprises. In addition, a few large banks in Canada’s centrally and regionally controlled, branch banking system dominate the sector. Elsewhere, the Canadian venture capital industry is tiny, curiously bureaucratic, and extremely risk-averse. By contrast, the American banking system is characterized by the presence of thousands of community banks, and a few, large, regional ones. American community bankers cannot afford to be risk-averse, and indeed are not. Thus, lending and investments in business enterprises thrive and generate large volumes of business. In addition, the American venture capital industry by comparison to the Canadian industry is huge *and* risk-oriented.

The reader can anticipate seven policy histories on small capital development for the period 1955 to 2005 -- although the story of state venture financing for small capital actually begins in 1943. The book is organized into two parts reflecting core functional activities pursued by state agencies: agenda setting and program development including implementation efforts. I borrow from the policy theory literature on policy cycles to express this temporal and functional taxonomy. The agenda setting and program development/implementation policy histories are offered in chapters three through nine, and are presented in more or less chronological order. In chapters three to six, I set out the agenda setting policy histories. These are: "Walter Gordon, Liberal Economic Nationalism and the Bureaucratization of Venture Financing Policy, 1955-1975," "Tax Reform and the Rise of Small Business Opposition Politics, 1962-1971," "Symbolizing National State Venture Capital: Ottawa's Policy Papers, 1976-1978," and "From Institutionalized Savings to Pension Funds Reform: The Rise of Small Business Investment Politics, 1978-1985." Chapters seven through nine focus on program development and implementation policy histories, including "Ontario's Venture Investment Corporations Program, 1973-1978," "Ontario's Small Business Development Corporations Program 1978-1983," and "The Federal, Labour-Sponsored Venture Capital Corporations Program, 1983-2005." A formal comparative analysis follows in chapter 10 and draws together all the comparative threads of the "Summary Analyses" appearing at the end of each policy history. Also in chapter 10, I discuss the overall problem of representation of small capital, and three governance problems directed toward international economic development practice.

On the original question: "Is the developmental state in Canada succeeding or failing on small capital development?" my findings show more failures than successes on matters of small capital agenda setting, program development and implementation. I conclude from the evidence that Canada in the policy field, small capital development, reveals itself as *a big, strong and failing state*. Indeed, this finding comprises my central thesis and confounds the findings of most theorists analyzing state economic development. Small capital development did not succeed, in general, because executive state leaders did not muster the political commitment; develop sufficient political skills or strategic acumen to achieve policy and program legitimacy, and senior bureaucrats did not attract and sustain the necessary expertise and knowledge on key policy and administrative tasks to demonstrate competence. I also observe that state-small business relations on the venture capital gap were not very productive. Entrepreneurs and proprietors almost never entered into direct consultations with state agents, let alone negotiations, and business associations, with one major exception, that purported to represent small capital interests were only occasionally effective. I identify various patterns of state-business success

and failure in these arrangements. Later, I highlight these participant structures in a series of stylized relations including: cooperative, pluralist, and network lobbying, governed interdependence, state functional representation, state commissioned and state subordinated lobbying, *concertation*, clientelism, defensive reaction, and so forth.

I find that historically Ottawa has not taken much serious, long run interest in its national, small capital sector. The national government has tended to treat the sector either with outlandish contempt, symbolic trivialization, or passive indifference -- in contrast to the treatment of small capital in the United States, Europe, and Japan. I conclude the Canadian state has failed in its small capital development mission after WWII because it has become so *detached and feckless*, even as it has remained the dominant institutional force. The Canadian state's record of unmet institutional capacity and the inability to represent small business on a regular basis has obscured its small capital development mission. We have glimpses of developmental success and functional representation of small capital, principally at the provincial level, but in the end this result has confirmed that developmental state has succeeded only periodically. The upshot of this record of failure leaves us with the clear impression that representativeness of small capital in the national state system is a problem, and therefore drives us to the larger issue of political underdevelopment in Canada.

Finally, I do not dwell in any detail on the range of venture capital policy-making experiences outside the Canadian provinces of Ontario and Quebec and the "national" government.<sup>6</sup> I concentrate on the central Canadian experience because it represents the earliest, leading, and the most significant treatment of state activity on the small capital development problem. Venture capital programs generated in these central Canadian jurisdictions, particularly Ontario, have been regularly replicated elsewhere in Canada. While Toronto, Montreal, Vancouver and Calgary are the most important nodes for private venture capital formation in Canada, it is the Toronto-Ottawa-Quebec City triangle that has been most important on the matter of *state venture financing* for small capital, particularly during the period under study.<sup>7</sup> This book therefore is a contribution to the short list of empirical studies on central Canadian state economic development and small business politics.

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<sup>6</sup> I use the term "national" throughout the book to denote the Government of Canada, and the term "federal" to denote the conjoint activities of the Government of Canada and the Provinces. The usual language adopted by political scientists and journalists in Canada is to use "federal" to describe the Government of Canada. I regard this usage to be conceptually inaccurate and technically improper.

<sup>7</sup> See Rod McNaughton and Milford Green, "Spatial Patterns of Canadian Venture Capital Investment," *Regional Studies*, 23 (1989) 1, p. 17 on private sector venture investment patterns in Canada.

My work has emerged from a long tunnel of deliberation and re-consideration in the hands of a private scholar. It started with my doctoral dissertation delivered to York University in Canada, which covered similar subject matter, if entirely different analytical issues. At the time, I was interested in the theory of program development inside the discipline of public administration. I completed the final drafts of the dissertation in 1985, and began a professional career outside academia in the same year. The chairman of my committee had previously suggested to me that I had written two dissertations, and that I ought to choose one for submission. I did so and left the other for the future. After many years this book became the highly elaborated result of the second dissertation.

A bigger and broader analytical approach was always the purpose of any subsequent effort. While participating in a small business policy conference in Washington D.C. in 1990, I was challenged by a British academic to respond the idea that all small businesses in North America were really subsidized by the state. While I immediately dismissed this bizarre notion, it did prompt me to rethink the relationship between small business and the state, and that I might have the material for such a re-consideration. Yet nothing much was done with idea until Ontario Finance Minister Floyd Laughren announced in 1993 that he was cancelling the single surviving program that I had canvassed in my dissertation. The times and other academic currents seemed ripe for a book on business-government relations featuring the small business sector. I already possessed the beginning, middle and the end of a story.

Sometime after moving the location of my professional practice to Florida in 1995, I began to revise the earlier work. From 1997 to 1998, I spent my spare time gathering additional research with my research assistant Ian Ball. Yet, I experienced a growing appreciation that at least one more side of the story was missing. That itch got scratched in January 1999 while on study leave at Harvard's Kennedy School of Government. There, among others, I met Merilee Grindle and was attracted to her work on state capacity and international development. With Merilee's kindness I quickly obtained leads on others in the field. This was a turning point. By January 2002 -- after four re-locations around North America -- I had the first draft of the new analysis with a very considerably expanded set of case studies. After waiting endlessly for a university press to respond, and then receiving two of the weakest reviews imaginable in late 2002, an epiphany of sorts struck. I decided to place my findings and analysis within the overall theme of state economic development, and then explore more fully questions of success and failure of state capacity and state-business relations. Two years of additional research and multiple re-writes and I had the third version of the book. After enduring three more re-locations around North America, the book was finished.