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Corporate finance and the governance implications of removing government support programs ☆

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ABSTRACT

Governments worldwide spend trillions of dollars on business support programs. This article examines the implications to investors of phasing out one of these subsidy programs. Our setting takes advantage of a unique quasi-natural experiment, where tax subsidies for Canadian Labour-Sponsored Venture Capital Corporations (LSVCCs) were phased out in one province but not in others. Using a difference-in-differences setting, we show that fund performance—unrelated to the tax credit—decreased substantially following the enactment of the phase-out. We further show empirically that LSVCC managers continued to charge venture capital-like management fees, despite the fact that their investment strategies become more similar to mutual funds. Our data strongly support the idea that investors in companies and/or funds that unexpectedly lose government support face significant financial costs.

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1. Introduction

Governments worldwide spend trillions of dollars on business support programs in the form of direct/indirect subsidies to firms or investors (Cressy, 2002; Keuschnigg and Nielsen, 2003, 2004a, 2004b; Colombo et al., 2011; Takalo et al., 2013). For example, the United States government has established Individual Retirement Account (IRA) and 401 k savings plans to increase individuals' savings rates (see, e.g., Engen et al., 1996; Gale and Scholz, 1994; Poterba et al., 1996; Venti and Wise, 1990). And the province of Ontario in Canada spends over C$4 billion per year on business support programs (Cumming and Johan, 2013). Other economies such as Germany spent billions in subsidies after reunification in order to boost the economies of the East German states (Dornbusch and Wolf, 1994). Furthermore, in order to combat the recent financial crisis, many governments worldwide implemented short-term subsidy programs.

Inevitably, however, subsidy programs must be phased out at some point, either because they are too limited, or because governments, and thus policies, change. This article empirically explores whether there are corporate governance or corporate finance implications of phasing out such programs, particularly with respect to any misconduct among those that lose government support.

To illustrate, consider tax subsidies on retirement savings. While many articles have focused on the effectiveness of these subsidies or on changes in savings behavior (Engen et al., 1996; Gale and Scholz, 1994; Poterba et al., 1996; Venti and Wise, 1990), there has been little research thus far on the cost impact

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to investors. Clearly, we expect to find costs for investors when subsidy programs end. Given the global importance and volume of such programs, it is somewhat surprising that we have so little sound empirical evidence on the implications of a phase-out of tax subsidies for investors.

Our main challenge here is to find compelling exogenous variation, and thus implement a convincing research design. For example, we consider a difference-in-differences approach using temporary subsidy or government support programs with a predefined phase-out, but this method will inevitably face an endogeneity bias. If managers and investors anticipate the end of a government program, this could lead to biased estimates. Hence, when considering a temporary business support program, we cannot be fully cognizant of the costs to investors after it is phased out. We empirically explore this question in a quasi-natural setting, where the phase-out of a long-term government support program is an exogenous event.

To provide empirical evidence, we first use the example of a repeal of a subsidy program for retail investors. In May 1985, tax-subsidized Labour-Sponsored Venture Capital Corporations (LSVCCs) were created in order to close the perceived venture capital (VC) funding gap in Canada, as well as to tap the retail market as a new source of VC funds. Similar funds called Venture Capital Trusts (VCT) were also established in the U.K. (Cumming and MacIntosh, 2007; Cumming and Johan, 2013).

Due to their high level of investment risk, VC funds are usually managed by expert fund managers (Kanniainen and Keuschnigg, 2003, 2004; Keuschnigg, 2004; Wang and Wang, 2010, 2012a,b; Wang and Zhou, 2004). In the past, such funds were available primarily to sophisticated institutional investors or to accredited high net worth investors. Such investors were able to not only take advantage of the diversification benefits of VC funds, they could also enjoy average historical realized returns that were significantly higher than those of traditional asset classes like equities or bonds. Thus, the Canadian government believed that the diversification benefits and return prospects—given fund manager selection and other restrictions—would also enhance retail investors' portfolio risk and return structure. In view of the potential benefits of increasing VC availability to entrepreneurs and the effect on national innovation rates, both the federal and provincial governments of Canada provided tax credits to retail investors in LSVCCs. This paper discusses why such good intentions may have ultimately been misplaced, and can end up costing retail investors dearly.

Specifically, we explore the value implications for retail investors who exploited or attempted to exploit the end of this program. The phase-out was first announced in 2005, but it was not carried out until 2008, and there was great uncertainty in between about the actual end date. Our identification strategy is based on a difference-in-differences setting that exploits regional differences, because the phase-out applied only to investors in one province (Ontario). Provinces where retail investors continued to enjoy the tax subsidy serve as our control group.

Since the introduction of LSVCCs, however, the literature has documented an underperformance of mutual funds and of the market when measured by, e.g., small-cap fund indices. This is despite the fact that these funds on average have expert management and accompanying "expert" rate fees, these funds on average have underperformed mutual funds and the market when measured, e.g., by small-cap fund indices. Moreover, extant research has established certain inadequacies of the LSVCC structure and some governance issues (see, e.g., Cumming and MacIntosh, 2007). For example, in 2008, after the final enactment that gradually removed the tax subsidies, LSVCCs in Ontario shifted their investment strategies from VC and private equity to public equity (Johan et al., 2014). The funds thus became more mutual fund-like in strategy, which led to a reduction in diversification benefits. However, they continued charging higher management fees than mutual funds (see Section 4.6 for more details).

We test the performance consequences of such shifts in investment behavior on the part of LSVCC managers in response to the regulatory changes. What differentiates our study is that we are able to analyze changes in tax structure in 2005 and 2008. This quasi-experimental setting enables us to overcome the key challenges of finding a convincing empirical strategy to study the effect of a tax subsidy phase-out policy on funds' return on assets (RoA) for Ontario versus non-Ontario LSVCCs. We are thus able to document the magnitude of the value-destroying effect caused by this phase-out-induced shift in investment behavior for retail investors.

Our non-parametric tests suggest that the returns in Ontario and the other provinces followed a common and parallel trend until 2007. Therefore, the announcement of the phase-out did not have immediate return consequences. However, as of 2008, the returns of both groups began to diverge, and the returns of Ontario LSVCCs dropped well below those in other provinces. To ensure this observation was not driven by cross-province differences in economic development, we also run a placebo test using Canadian mutual funds across all provinces. We find that the returns of the Ontario funds and the other Canadian mutual funds followed parallel paths over the entire sample period. This observation implies that the difference in returns after 2007 is a consequence of the tax subsidy phase-out and not a different trend across provinces.

Our difference-in-differences estimation allows us to control for other potentially confounding factors that may affect RoA, such as fund size, investment strategy, management fee, number of VC investments, and local GDP. We find consistent evidence that the tax subsidy phase-out had only a small effect around the announcement date. The negative return effect occurs in Ontario after the final enactment, and is substantial: The RoA of Ontario LSVCC funds was 16.4 percentage points lower than that of LSVCC funds in other provinces. This is significant given the −3.6% average LSVCC fund return over the sample period. Furthermore, because investments were typically "locked up" for a minimum of eight years, only a small minority of investors would have been able to adjust their savings behavior when the tax subsidies were phased out. However, even if they could have responded, it is not clear that investors would have adjusted their behavior. Consider a study by Chetty et al. (2013), for example, that showed 85% of Danish individual investors behaved passively when tax subsidies on retirement savings changed.

Our study contributes to the debate on subsidies and government support programs in the following ways. First, we contribute to the literature on tax subsidies and savings (Engen et al., 1996; Gale and Scholz, 1994; Poterba et al., 1996; Venti and Wise, 1990). We find that removing the tax subsidies resulted in changes in funds' investment behavior. It also proved contrary to the interests of retail investors, who sought to benefit from the higher returns of high-risk VC investments while diversifying their investment portfolios with VC. Some managers instead destroyed the value of their portfolios.

Second, our findings have implications for redesigning tax policies and potential fund regulations. Other Canadian provinces are considering phasing out tax subsidies, while some jurisdictions such as the U.K. are increasingly revisiting their own policies. Following the Ontario government's tax subsidy phase-out policy, the Canadian federal government announced plans to gradually remove the federal tax credit for LSVCC investors by the end of 2016.[1]

[1] See the Government 2013 Budget Plan at http://www.budget.gc.ca/2013/doc/plan/chap3-4-eng.html#a25-Phasing-Out-the-Labour-Sponsored-Venture-Capital-Corporations-Tax-Credit.

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