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Resizing the Pie

Ottawa should cut business subsidies — and business taxes.

Christopher Ragan
McGill University

As U.S. President George W. Bush continues his push for a tax cut, many Canadians are wondering whether we should expect further income-tax cuts in the Great White North. The answer is no. While I like lower taxes just as much as the next guy, there are several reasons why now is not the time for large cuts in personal income taxes.

Why not now? With a slowing economy, isn't this the ideal time to reduce personal taxes and stimulate the economy? No. It's true that reducing personal income taxes would give a boost to consumer spending, and this would help to dampen the economic slowdown. But there are two problems. First, most economists agree that monetary policy is a better way of influencing demand. It works more quickly and is less politically motivated. So let the interest-rate cuts that the Bank of Canada has already implemented take effect. The second problem is the appropriate policy focus. The last time governments actively used taxes and spending to stabilise the economy, in the 1970s and early 1980s, the focus was entirely on the short-run level of demand; the long-term accumulation of government debt was ignored, a mistake that we will be financing for years.

Talking about debt, let's not forget how much we still have. Despite Paul Martin's success in slashing the federal budget deficit, the stock of debt is still very high, and the $45 billion in annual interest payments gives the government little room to manoeuvre. The government's net debt is currently $565 billion, approximately 52% of GDP. In the United States, the debt-to-GDP ratio is only 44%, and so they have a lot more room for making large cuts in personal taxes.

Of course, if the federal government is prepared to cut its spending significantly, there would be room for both lower taxes and continued debt reduction. But then we have to ask which programs get the axe. And there's the rub. Canadians are committed to a variety of social programs, and federal spending on these programs, much of which is done through transfers to the provinces, makes up 64% of total program spending. No spending category — with the sad exception of debt charges — comes close in size. I’m the first to admit that many of these programs could be improved and trimmed. But even in their ideal form, the social programs that Canadians want are expensive. And the blunt truth is that high taxes are necessary to finance these programs.

So if we’re unwilling to cut spending on social programs, where else can the axe fall? The only way the federal government can afford to make serious tax cuts is if it suddenly sees the light and decides to slash some of its sillier expenditures. At the top of the Silly Spending List are subsidies to individual firms, especially some of those that are doing so well. (Need I even mention the name of the Quebec-based aerospace and transportation firm that continues to rake in the bucks from Ottawa?) Only slightly lower on the Silly Spending List is long-term financial support for Canada’s farmers. Temporary disaster relief for farmers is one thing, but the case against long-term support is as solid as the case against the government selling shoes or opening restaurants or managing your RRSPs.

Though I am strongly in favour of eliminating this kind of silly government spending, I recognise the power of vested interests and I am no longer naïve enough to expect these policies to disappear anytime soon. As is so often the case, good politics is based on bad economics. But Canadians who want lower personal income taxes should recognise the forces at work. The current government — and the same will be true when Paul Martin takes over in a few years — will only be convinced to reduce taxes if they are also convinced to take the courageous position of eliminating their age-old commitment to corporate welfare. And they will only be so convinced if Canadians start complaining.

But even if we suppose that the government is ready to completely eliminate its silly spending, the case for *personal* income-tax cuts is weak. If the government has the fiscal room to cut taxes, it should go after the tax cut that produces the largest improvement in Canadians’ long-run living standards. All tax cuts are not the same.

Canada’s biggest economic challenge is to increase our rate of productivity growth — the single most important factor for long-run improvements in living standards. Higher rates of productivity growth mean that, on average, we can have higher incomes or more free time or both. Higher average incomes also mean that more resources are available to be spread around to the less fortunate. So people on both ends of the political spectrum should be united in the push for higher productivity growth. We all know that Canada’s productivity growth has paled in comparison with U.S. productivity growth, and as a result the gap in average incomes has widened. What can be done in Canada to close this income gap?

One of the most striking empirical findings in macroeconomics is that countries with high rates of investment in plant, equipment, and R&D, also have high rates of productivity growth. This should not be surprising. R&D produces new knowledge and much new knowledge is embodied in new capital equipment. So more investment of all types increases our knowledge and our productivity, and in the long run drives our living standards.

So if the federal government does cut its spending and is then looking for taxes to cut, it should cut those taxes that most inhibit investment — corporate income taxes. Reducing corporate taxes will make investment of all kinds more attractive, increase the economy's level of capital and technical knowledge, increase workers' wages, and raise our living standards. Many people will object to such a tax cut on the grounds that businesses should pay their "fair share" of taxes. But all businesses are, ultimately, owned by individuals and it is simpler to tax the income when it accrues to the owners. Whatever income remains within the company is then free to add to investment and to productivity growth. The end result will be better jobs and higher incomes for all Canadians.