

ECONOMY DOCUMENT

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When the Conservatives came to power two years ago, they inherited the strongest fiscal position and the strongest employment growth in the G7. With all of its inherited surpluses, the government had an opportunity to make smart investments and wise tax cuts that would have strengthened Canada's productivity and better prepared the country for the uncertain economic times that confront us today.

In fact, the government's economic record is a story of wasted opportunity and foolish initiatives.

- The government went on a big spending spree while times were good, while still managing to cut spending in areas that would make Canada more productive (research and innovation) and in areas of desperate need (e.g. forestry and illiteracy).
- The government engaged in the most economically foolish tax cuts, principally GST and politically driven boutique tax credits, thereby throwing away a golden opportunity for broad-based income tax cuts.
- The government destroyed \$25 billion of Canadians' hard-earned savings when it broke its promise on income trusts, and its budget proposal on interest deductibility was a frontal attack on the competitive position of Canadian companies.
- Just as economic hard times are upon us, the government finds its fiscal cupboard largely empty. It has little fiscal capacity to support jobs and the economy at the moment of need – unless it decides to return to deficits.
- The government is also hobbled by its laissez-faire ideology that leaves everything to the markets. Even though US governors are bidding for auto plants to locate in their jurisdictions, the government refuses to invest in sectors like manufacturing and forestry that have been devastated by the high dollar, high energy costs and a slowing US economy.

ECONOMIC OUTLOOK

Today the United States is at best in a period of sharp slowdown and quite possibly in recession. Banks around the world have so far written off more than \$100 billion related to the sub-prime mortgage crisis, with some estimating that write-offs could rise to \$500 billion. US house prices are tumbling, prices of gas at the pump have risen sharply, and US consumer confidence has fallen to levels not seen since the recession of the early 1990s.

At home, the Bank of Canada has substantially downgraded its economic growth forecast for 2008, from 2.4% to a puny 1.8%. Ontario, with some 90% of its exports destined to the United States, is most at risk of recession. Several sectors, including manufacturing and forestry, have been caught in a perfect storm of a high dollar, rising energy costs and

a slowing US economy. The manufacturing sector has lost 131,000 in the past year, and Jim Stanford, Chief Economist of the Canadian Auto Workers union projects a further 300,000 lost jobs over the next two to four years if the dollar stays anywhere near parity.

One respected Canadian economist summarized the outlook as follows – probability of a recession in US **and Ontario** is 50%, while probability of recession in Canada as a whole is one in four.

LIBERALS ARE THE PARTY OF FISCAL PRUDENCE

On both sides of the border, history shows that it is Conservatives or Republicans that run big deficits, leaving it to Liberals or Democrats to clean up the mess.

In the United States, Ronald Reagan's supply-side economics resulted in record deficits in the 1980s, while Bill Clinton ran an unbroken string of surpluses in the 1990s. Under Republican George Bush, the US is again running large deficits, and it will be up to the next President and Congress to clean up the mess.

In Ontario, the Eves government, which included Jim Flaherty, John Baird, and Tony Clement, ran on a balanced budget in 2003. However, when Dalton McGuinty won the election and called in the auditors, he discovered he had been left with a \$5.8 billion Conservative deficit.

In Canada, the Chretien Liberals inherited a \$42 billion Conservative deficit from Brian Mulroney in 1993. They proceeded to clean up the mess and ran uninterrupted surpluses from 1997 onwards.

While it would certainly conform to the historical pattern, it is premature to accuse the Harper government of taking Canada back to deficit financing. Nevertheless, through their actions over the past two years, they are certainly skating closer to the line than their predecessors did.

CONSERVATIVES ARE THE BIG SPENDERS

Many Canadians will probably be surprised to hear that it is the Harper Conservatives, not the Liberals, who are the big spenders. Yet this point is very clear from Table 1.

Over their two years in government, total program spending by the Harper government went up 6.4% per year. The corresponding figure for 13 years of Liberal government is only 2.3%. If one excludes the years of deficits and considers the 8 years from 1997/8 to 2005/6, then program spending under the Liberals went up by 5.5% per year.

Notwithstanding their talk of "fiscal balance", Conservatives have been relatively stingy in raising transfers to other levels of government. The bulk of their spending spree consisted of direct spending by the federal government, which went up by a whopping 18.0%, or 8.6% per year. This is far greater than the record of Liberal governments.

“He (Flaherty) has become the biggest-spending finance minister in the history of Canada. It’s a sad achievement but well-earned since Canada's New Government is now 14% bigger after two Flaherty budgets.”

(Andrew Coyne)

While Conservatives are the bigger spenders overall, this didn’t stop them from making foolish cuts – cuts in areas favouring Canada’s competitiveness (e.g. university and other funding for research and innovation), cuts to sectors in dire need (e.g. the Liberal forestry program), and mean-spirited cuts to vulnerable Canadians (e.g. women’s programs and literacy programs).

Table 1
Annual Increases in Government Spending:
Liberals versus Conservatives

	Total program spending	Direct federal spending
Liberal governments 1992/3 to 2005/6	2.3%	3.2%
Liberal governments After balancing budget 1997/8 to 2005/6	5.5%	5.0%
Conservative government 2005/6 to 2007/8	6.4%	8.6%

Sources: *Fiscal reference tables*, September 2007; *Economic Statement*, October 2007

FOOLISH CONSERVATIVE TAX CUTS

Beginning with the \$100 billion tax cut initiated in 2000, Liberals have long believed in broad-based personal income tax cuts. Unlike GST cuts, which only encourage consumption, income tax cuts encourage Canadians to save, invest and work. Particularly at a time of aging population, Canada needs income tax cuts rather than GST cuts to build a more productive, competitive economy.

There is scarcely an economist on the planet who would disagree with this statement. From the OECD to the IMF to individual economists, the Harper move to cut GST was greeted with a universal thumbs down. Even business leaders joined the fray, albeit cautiously. For example, one-time Conservative cabinet minister Perrin Beatty, the president of the Canadian Chamber of Commerce, recently wrote, “Knocking another

point of the GST may be politically attractive, but it does not provide for improving our sustained economic performance.”

The two point cut to the GST is hugely expensive at some \$12 billion per year, or \$60 billion over five years. Think of the far better things that could have been done with that money!

Here’s one example:

- Cut the first income tax rate from 15% to 13%
- Cut the second income tax rate from 22% to 20%
- Cut the third income tax rate from 26% to 24%
- Use the remaining \$2 billion per year to provide a big boost to the GST credit, which would be of major benefit to low income Canadians who pay no income tax

This is just one of an infinite number of better things that could have been done with \$12 billion per year. It’s not necessarily the best choice, but it’s certainly better than what the government did.

The second foolish tax policy of the government was to engage in small, politically motivated tax credits rather than general income tax cuts for all. Particularly silly is the textbook tax credit for postsecondary students when the great bulk of students don’t have enough income to benefit from this credit. Why not put money directly into the pockets of low and middle income students rather than engage in such gimmicks?

Why is it up to the government to give tax breaks for families with young hockey players, but no tax breaks for families with young piano players? Liberals believe in general tax relief for all families, allowing families, not government, to decide between hockey and piano lessons. It is Conservatives, not Liberals, who are the social engineers.

The government has enacted two other tax measures. First they raised the lowest personal income tax rate from 15% to 15½ %, falsely claiming they were cutting the rate rather than raising it. Then, with great fanfare, they reduced the rate from 15½% to 15%. So the net effect has been to get back to where we were under the Liberal government, with a one year Conservative tax grab along the way.

The other tax measure was to move towards deeper cuts in the corporate tax rate, a move that was advocated by the Liberal leader advocated before it was adopted by the government. We need to create a new Canadian advantage now that we’ve lost our cheap currency “advantage”. A ten point gap between US and Canadian corporate tax rates will provide a big boost to companies deciding to invest in Canada rather than the United States. So this is the one dimension of Conservative tax policy that we Liberals support. But unlike the Conservatives, we do not see a lower corporate tax regime as a panacea or magic bullet that will solve all our problems. It’s an important arrow in our quiver, but it’s not the only arrow.

FOOLISH CONSERVATIVE ECONOMIC POLICIES: INTEREST DEDUCTIBILITY AND INCOME TRUSTS

It is in the areas of interest deductibility and income trusts that the Finance Minister has demonstrated that he's out of his depth and simply doesn't think before he acts.

As well known tax expert Allan Lanthier, immediate past chairman of the Canadian Tax Foundation, stated the interest deductibility policy was "the worst tax policy to come out of Ottawa in 35 years". It would have weakened Canadian companies, forcing them to operate with one hand tied behind their backs and making them more susceptible to foreign takeover. Thankfully, a combination of business pressure and pressure from the Liberal Party caused the Finance Minister to rip up his budget's proposal in this area – but the episode speaks eloquently to the point that he's out of his depth.

The first thing to say about the Conservatives' income trust policy is that it was a flagrant broken promise that caused \$25 billion of Canadians' hard-earned savings to go up in smoke in a single day.

The second thing to say is that it was based on a false premise. The notion that income trusts give rise to substantial tax leakage and tax unfairness has been discredited by experts. All the government has in its defence is its infamous blacked out document in which it refuses to disclose the basis of its calculations to Canadians. In our view, this open disregard for transparency and accountability is a matter for the Auditor General to investigate.

The Liberal plan is clear. Upon forming government, we will immediately scrap the government's punitive 31.5% tax proposal and impose a 10% tax at the entity level, refundable to Canadian residents. Experts tell us that this move will return approximately two thirds of the lost market value to the income trust sector.

LAISSEZ-FAIRE / I DON'T CARE

Much of Canada's forestry sector is on life support. Manufacturing is in crisis, in the perfect storm of a high currency, a flagging US economy and rising energy costs. Agriculture, tourism and other exchange rate sensitive sectors are also in major disarray.

Yet the Harper government refuses to act. Their \$1 billion communities fund kicks in only AFTER people have lost their jobs – and also, in a disgraceful display of politics, only AFTER Parliament has passed their budget.

What is needed today is a willingness of the federal government to invest in sectors that are in this perfect storm. Liberals believe in fiscal prudence, but we also believe in active government. Conservatives, it seems, are hamstrung by both their laissez-faire ideology and their "I don't care" attitude. Leave it entirely to the market. That's the Flaherty/Harper mantra.

Let me be clear. As an economist who believes in markets, I think the planet would be a better place if all government subsidies to business, including agriculture, were ZERO. But that's not the real world.

The United States and the EU offer massive subsidies to agriculture and aerospace. US governors are now seeking money from George Bush to help them lure auto plants to their jurisdictions. In that context, the real world context, it is only a boy scout Canadian ideologue that would denounce all government investment in industry on ideological grounds.

Stephen Harper is an immensely controlling Prime Minister. But his writ doesn't extend to the United States and the European Union. He can't stop foreigners' subsidies to industry. So are we going to proceed in ideological pristine purity and eschew all subsidies, or are we going to be a part of the real world?

That's the question. And the jobs of hundreds of thousands of hard-working, ordinary Canadians hang on the answer. Stéphane Dion's answer is clear. He's committed to a \$1 billion fund to support manufacturing, and he's also committed to match or more than match the Conservatives' communities fund.

The problem is that Jim Flaherty is mired in the world of mindless Mike Harris style ideology. His zero subsidy philosophy is based on the world as he would like it to be, rather than the real world that exists today.