

Most Favored Nation

Building a Framework for Smart Economic Policy



Jack M. Mintz

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1 *Public Policy and Global Economic Integration*

The twenty-first century presents Canadians with a new set of choices. After two decades in a public sector straitjacket, we have virtually eliminated federal and provincial deficits and entered a new era of *fiscal surpluses* (where revenues exceed public expenditures). Canadian federal and provincial politicians are in the enviable position of being friends to all people; they no longer have to face cutting spending or raising taxes. They can reduce government debt, increase public expenditure, or reduce taxes, policies that favor some citizens without hurting others. Any minister of finance could take the well-known path of simply dividing the surpluses between restoring spending and cutting debt and taxes.

Meanwhile, however, a new phenomenon is rising over the horizon. During the past two decades, the international environment has changed radically. Canadians are now on Internet time. Changes to our economic environment from new technologies are so rapid that business decisions are made within days, even hours, rather than years. New communications and transportation technologies allow businesses to seek around the world for both customers and the cheapest supplies. Businesses are consolidating across borders. Financial capital moves across national boundaries

at the push of a button. Exchange-traded financial transactions are now US\$13.5 trillion, and average daily turnover in foreign currency markets is US\$1.5 trillion per day.¹ Canadian firms, once reliant on capital inflows, now invest as much in other countries as foreign firms invest here. The stock of foreign direct investment by Canadian businesses as a proportion of gross domestic product (GDP) has more than doubled from 9 percent in 1980 to 18 percent in 1999 (Canada 1998, 3.10). Almost a quarter of industry sales is direct or indirect exports to foreign markets (*ibid.*, 3.9).

The consequence is that international location has become an important influence on business decisions. Although people may prefer to locate at home,² the environment with which they are most familiar, the reduction in communications and transportation costs has eased setting up shop in foreign countries. Thus, people increasingly are willing to compare countries' economic environments in determining the location of business activities.

Also, although the number of migrants across national boundaries has declined in terms of total populations, there is good reason to believe that labor markets are becoming increasingly integrated at the international level. Firms seek talent globally and sometimes move production to where people want to live, rather than move people to where the business is located. At the same time, in industrialized countries the workforce is aging and fertility rates have been low; as a result, the percentage of the population of working age may plateau within the next two decades (OECD 2001). Labor shortages will abound, and industrialized countries will seek immigrant workers of all skills from global labor markets. People will become more mobile in a globally integrated world.

These changes are creating a new economic order. Governments of the industrialized countries will be competing to improve

1 Taken from Bank for International Settlements surveys; see White (1998).

2 Helliwell (2000) lucidly points out that borders are still "thick" in that people and businesses are more attracted to trade at home than in other markets. As his review of the data shows, however, borders are becoming thinner in the sense that goods, services, and capital flow more easily across them.

opportunities for incomes and jobs for their citizens. Such competition will mean that the jurisdictions that provide the best package of spending and taxes will be able to attract jobs and people. Therefore, governments will have to look increasingly hard at the role they play in the economy. Currently, they account for a third to a half of the economies in industrialized countries. Their expenditure, tax, and regulatory powers have a significant impact on the economic opportunities available to their populations. If they spend tax revenues wisely in the coming years, they can offer a package of services that will attract and retain businesses and jobs. Inefficient spending and poor tax policies will impose high economic costs, undermining the economy's ability to grow.

Canadians have two choices in responding to the global economic order. We can try to minimize its impact by, say, adopting policies to protect traditional industries, restricting foreign businesses from operating here, reducing opportunities to harness technological developments from abroad, and spending taxpayers' money to counteract the impact of the knowledge-based global economy on declining industries. Or we can embrace the opportunities of global economic integration by supporting strategic public policies that create a distinctive Canadian advantage: smart public expenditure and tax policies that encourage residents to adopt the skills needed for businesses attracted to Canada as a strong economy.

This study focuses on the role of government³ in the twenty-first century. It evaluates how public expenditure and tax policies can contribute to creating the Canadian advantage in a world with mobile capital and jobs.⁴ I use a relatively new methodology to

3 Throughout, I tend to concentrate on total government expenditures and taxes. The book addresses policy issues at all levels of government, and there is little discussion about the interaction of federal, provincial, and municipal policies, despite the high degree of their importance to Canada as a federation. I do not try to analyze the state of federal-provincial relations and how they could be improved. Doing so would require another book.

4 Given the difficulty of measuring the impact of regulatory policies on the cost of doing business, this study does not consider them. Regulations can enhance...

measure the effects of spending (on education, health, infrastructure, and research and development) and of taxes (personal and business) on the cost of doing business in Canada. Putting these effects together, I calculate their combined impact on the cost of doing business in Canada and compare it to that in the United States, our largest trading partner, for various industries.

The overall conclusion is that current Canadian government expenditure and tax policies create a disadvantage for production that takes place here rather than in the United States. Even though recent federal and provincial initiatives are reducing the existing disadvantages in creating jobs in Canada, they still have some way to go. Overcoming these disadvantages is possible. It would mean further reduction in public debt, lower taxes, and increased efficiency in public programs that would also improve their effectiveness and equity. I recommend policies that would not only remove the disadvantages but also create a distinctive Canadian advantage in today's global economy.

Thus, the objective of this book is to outline a vision for the role of federal and provincial governments. In the next chapter, I describe in more detail how the process of internationalization affects economic development in Canada. The third chapter describes the evolution of the role of federal, provincial, and municipal government expenditures in this country and how it compares with that in the United States. The fourth chapter examines how expenditure and tax policies currently affect the cost of doing business in Canada. The fifth chapter offers policy recommendations that would result in a distinctive Canadian advantage by making government policies more effective. The sixth chapter is a brief conclusion.

Note 4 - cont'd.

...the efficiency of markets but also impose significant compliance costs. To evaluate the impact of regulations, it is necessary to measure both the benefits and the costs they impose on markets, a calculation requiring data that are currently not available.
