

Intelligence MEMOS



From: John Lester and Alexandre Laurin
To: Canada's Budget Observers
Date: July 15, 2025
Re: **OTTAWA'S COST-CUTTING AXE NEEDS TO SWING MORE WIDELY**

The federal government has promised a spending review aimed at limiting the growth in its operating spending, also known as direct program expenses, to two per cent a year. With the new NATO commitment to increase defence-related spending by more than \$100 billion a year by 2035, restraining non-defence spending is exactly what Canada needs right now. Without it, the tax burden on current and future generations will become untenable.

But the spending review needs to cover all current spending. By our reckoning, limiting the review to just operating spending means it will cover only a third of spending.

Direct program expenses, which the review will cover, represent less than half of what Ottawa spends in a year. They include operational costs, such as the wages of public servants, and subsidies, but exclude major transfers to provinces, municipalities, families, and seniors. And the Carney government appears set to further narrow the scope of the spending cap by excluding business subsidies that support investment, as well as infrastructure-related transfers to provinces and municipalities.

For example, payments under the critical minerals strategy are currently part of direct program/operational spending and under the new approach they will be shifted to a new category of capital expenses and therefore may be exempted from the 2-percent growth cap. According to the Liberal election platform, this reclassification of capital spending will shift approximately \$18 billion out of program spending in the current fiscal year. In addition, about \$35 billion in new initiatives will be classified as investment.

It's worrying that the platform makes the definition of capital spending highly flexible: Measures that "meaningfully raise private sector productivity" will be classified as investment. Because keeping "operating spending" to just 2-percent growth will require difficult choices, the government will be sorely tempted to arbitrarily classify even more spending as non-operating. And, in any event, it is unclear why capital expenses on federal infrastructure should be excluded from review.

Another loophole preventing a review of all spending is that Ottawa doesn't just support things by giving people money who do them; it also supports things by not taxing people who do them. Such tax concessions to achieve policy goals – commonly known as "tax expenditures" – should be part of the review, too. Consider support for cultural industries. Programs supporting production of books, music, and periodicals are classified as operating spending and therefore included in the review. But support for Canadian film and video production, which is mainly delivered as a tax credit, is not.

To spread the burden of expenditure restraint among all the beneficiaries of government programs, tax expenditures need to be included in the spending review. If they are, the resulting perception that the burden is shared fairly will make it easier to implement.

We estimate there are about \$54 billion in tax expenditures that are comparable in purpose and function to direct spending programs. (Another \$100 billion or so in tax expenditures address problems such as the tax treatment of savings and income paid to non-residents, which makes them more of an issue for tax reform than for a spending review.)

The Liberal election platform recommends that transfer payments with similar objectives be consolidated within a single department. That's a sound approach and it should be extended to include tax expenditures. This would involve shifting responsibility for managing and evaluating tax-based spending from Finance Canada to the departments that oversee the relevant policy areas. For example, Innovation, Science and Economic Development Canada (ISED) should be responsible for all business R&D support programs, including tax credits. Consolidation would allow ISED to ensure that R&D programs are complementary and that resources within the spending envelope are efficiently allocated.

A spending review is a welcome step. But its 2-percent growth cap would only apply to roughly a third of total spending and tax-delivered programs. Limiting the review to this extent is a mistake. It should be broadened to cover all federal spending to ensure taxpayers are getting full value for money.

John Lester is a fellow-in-residence at the C.D. Howe Institute, where Alex Laurin is vice-president and director of research.

To send a comment or leave feedback, email us at blog@cdhowe.org.

The views expressed here are those of the authors. The C.D. Howe Institute does not take corporate positions on policy matters.

A version of this Memo first [appeared](#) in the Financial Post.