

CUPE ECONOMIC

BACKGROUND

Taxes, Productivity & Competitiveness: It's Not the Tax Cuts that Matter...

Quality public services deliver a more competitive economy and a better quality of life

Finance Minister Jim Flaherty says he wants to cut taxes more in order to increase Canada's productivity growth, spur competitiveness and boost our economic growth. "A competitive economy requires competitive taxes. We will increase our Canadian tax advantage even further over time,"¹ Flaherty said.

The idea that lower taxes – and consequently lower public spending – leads to a more productive and competitive economy is taken as gospel by Conservatives. It is increasingly perpetuated by the media and accepted by the public.

Prime Minister Stephen Harper has suggested that this is an irrefutable law of economics: "I am an economist. I believe that all taxes are bad. It's always good to keep taxes down."²

But where does this notion come from? And what does the evidence show?

Economics 101 teaches that, under certain assumptions, free and competitive markets will lead to the greatest level of good for the greatest number of people. In this model, taxes, government spending and regulation interfere with the free market and are therefore bad.

Economics 201 teaches that these assumptions are highly simplistic, heroic and unrealistic; that "market failures" are pervasive; and that there is an important role for public spending, taxes and regulation that improve the economy and increase well-being.

The level of government action that increases the overall level of good in society is a matter of ongoing and extensive debate, but no credible economist really believes that *all* taxes are *bad*.

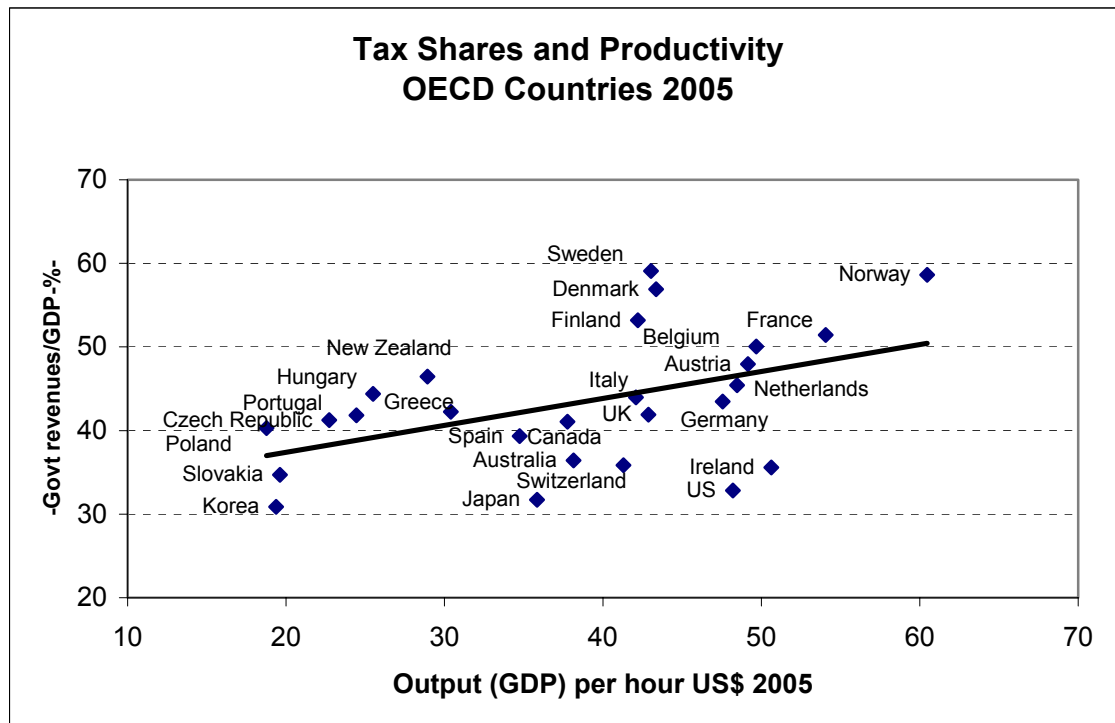
However, Harper and others have elevated this simplism to a guiding law of economics, when it is really just a tenet of conservative political ideology.

¹ *GST cut just the start*, Flaherty says, (G&M June 30, 2006).

² *Harper, Martin clash on tax-cut proposals* (G&M Dec 1, 2005.); Harper vows to reduce GST, CBC News Dec 1, 2005.

So if economic theory doesn't actually say that "all taxes are bad", what then does the real world show? If what Harper and Flaherty believed were true, then countries with low tax rates and low public spending should be more productive and more "competitive".

Taxes and Productivity



Many economists have tried to link higher taxes with lower rates of economic growth, but they have done so with little success. On the contrary, most "top-down" studies have demonstrated a weak relationship, if any, between tax rates, size of government and economic productivity.

However, simple correlations show a *positive* relationship between the tax share of Gross Domestic product (GDP) and hourly productivity for OECD countries. As Jackson (2000), Sharpe (2002) and Lee (2004) have shown, countries with the high productivity, such as Norway and France, also have above-average levels of revenue as a share of their GDP.³ France, often derided by economists for its social programs, long holidays, and "inflexible" labour policies, has a much more productive workforce than Canada, the UK or the United States.

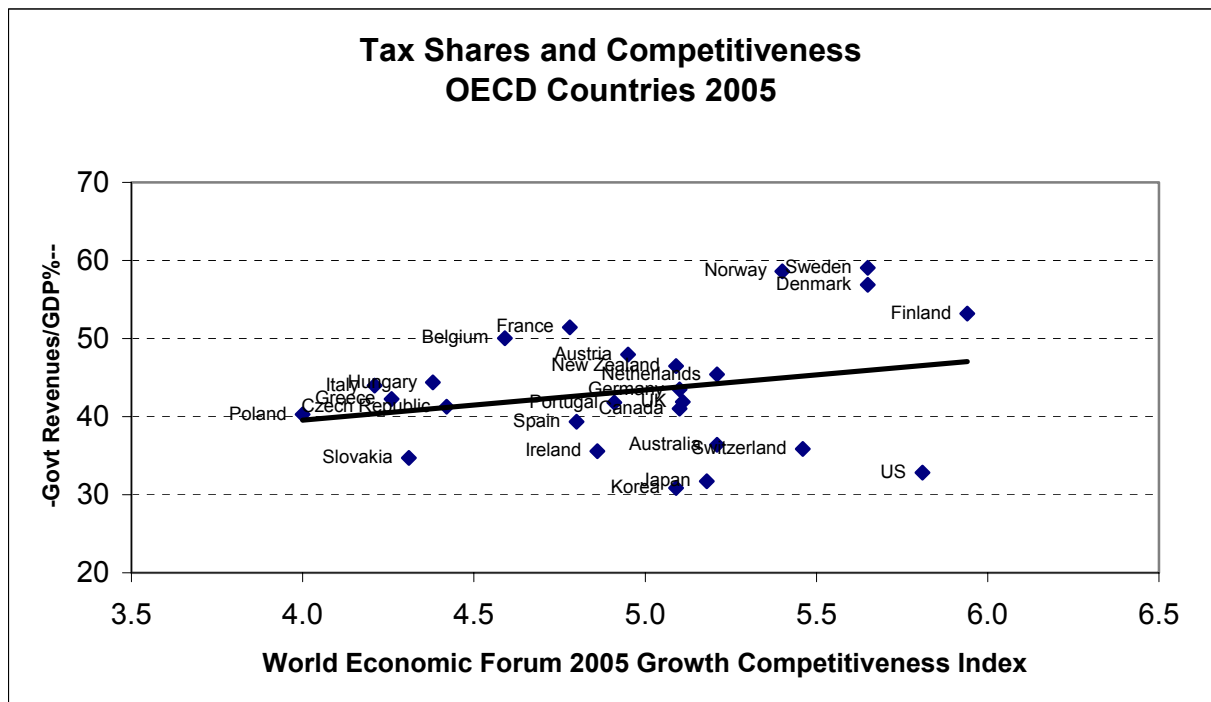
³ See Jackson, Andrew (2000). *Tax Cuts: The Implications for Growth and Productivity*, (Canadian Labour Congress; Sharpe, Andrew (2002)). *Smart Economic Policy for Whom?* (Canadian Tax Journal, vol. 50 no. 4, pp. 1341-53; Lee, Marc (2004)). *Size of government and economic performance: What does the evidence say?* (CCPA-BC).

Despite claims that we need to reduce our top tax rates to stimulate investment and productivity, there is also no evidence that this would do so. Countries with higher top marginal tax rates also have higher levels of productivity.

International comparisons of productivity growth over time are difficult to calculate in an unbiased manner because of timing differences between economic cycles and value-laden econometric analyses. Causality and measurement are also issues: do higher incomes lead to more public services or do greater public services spur income growth?

There is a general tendency for the economies of lower-income countries, often with proportionally smaller governments, to grow faster, as more of their activities become part of the formal market. But it certainly doesn't follow that higher-income countries should shrink their governments to increase their economic growth.

Taxes and “Competitiveness”



There also appears to be a positive but weak relationship between tax shares and “competitiveness” scores, as calculated by the pro-business World Economic Forum (WEF). The most growth-competitive country in the world, according to the WEF, is Finland, where tax revenues and the government sector accounts for over 53% of their economy, compared to 41% in Canada.

Four other Scandinavian countries with relatively high tax rates, including Sweden, Norway, Iceland and Denmark, all ranked in the top 10 places. As the latest report noted:

“There is no evidence that relatively high tax rates are preventing these countries from competing effectively in world markets, or from delivering to their respective populations some of the highest standards of living in the world.”⁴

These countries tend to have very progressive income taxes, relatively high consumption taxes, lower taxes on capital, and higher payroll taxes.⁵ The point isn't that higher taxes increase competitiveness and productivity, but that adequate tax revenues are needed to provide quality public services. These countries also invest heavily in people – “human capital” – through public health care, education, training and child care. They don't blindly rely on the “free market” to provide inadequate and unequal levels of these services.

Dynamic companies need to attract and retain talented, creative and committed people. Such people are attracted by a high quality of life and vibrant communities – not simply by low taxes. Scandinavian countries also rank very high on measures of environmental sustainability, government transparency, social equality and overall quality of life.⁶

As Lee (2004) and others have pointed out, what is important is not so much the overall level of taxes or the size of government, but the *quality* of government, the mix of taxes and where and how public money is invested. It's not the size that matters, but what you do with it.

Over the past few years, many governments around the world have cut taxes on capital and on corporate income on the rationale that this will stimulate investment and productivity growth. Canada now has considerably lower taxes on corporate income, capital gains, and research and development activities than the U.S.

In fact, Canada is still the cheapest place to do business among all G7 countries, according to a recent study by the firm KPMG, with business costs 5.5% lower than the U.S.⁷ But these lower taxes and lower costs haven't translated into much higher levels of productivity or competitiveness.

⁴ *Global Competitiveness Report 2005-6*, Geneva, Switzerland. p. xv. (World Economic Forum (2005)).

⁵ *Taxing Wages 2004-5* and OECD Tax Database. See (OECD (2006))

⁶ United Nations *Human Development Index*, various years; Center for International Earth Science Information Network (CIESIN) of Columbia University (2006) *Environmental Sustainability Index*; (Transparency International (2005). Corruption Perceptions Index 2005;)

⁷ KPMG (2006) *Competitive Alternatives*.

Business tax rates are currently so low, and profits so high, that corporations in Canada and the G7 now have unprecedented levels of excess cash that they haven't reinvested into the economy to increase growth and productivity.⁸ Instead, corporations have poured billions into mergers and acquisitions. They are behind the push for governments to privatize and engage in costly public private partnerships (P3s). They are doing this because they have a lot of extra money and they want a low-risk way of generating high returns – not because it will save governments money or increase productivity.⁹

Public Investments Spur Productivity Growth

To increase productivity, governments need to directly re-invest in the economy and not just rely on the private sector to do this through tax cuts. For years now, governments in Canada have underinvested in physical infrastructure such as transit, roads and municipal services.

Not only does public investment provide direct and broad social and economic benefits, but each dollar invested in public infrastructure is estimated by Statistics Canada to provide 17 per cent in cost savings *per year* for Canadian businesses.¹⁰ These public investments spur greater private sector investments and opportunities thereby further increasing productivity. But there is little evidence that large increases in military spending helps to improve the economy, increase productivity, or even enhance security.

Direct public investments in transit will do a lot more to improve services and increase ridership than tax breaks will, just as investments in community and school sports facilities will do more to encourage physical activity for children than tax credits for private sports programs.

Investments in physical infrastructure are only part of the equation. Investments in human and social capital – things that strengthen the fabric of our communities and improve our quality of life – are being increasingly recognized as critical for improving productivity. Much more needs to be invested directly into education, public services and other areas that enhance the quality of life in our communities.

For instance, investments in a publicly funded child care program would do a lot more to improve overall wellbeing and economic productivity than providing direct allowances or tax breaks. A recent U.S. study by the prestigious Brookings Institution estimated that investing in a high-quality universal

⁸ IMF (2006). *"Awash with Cash: Why are Corporate Savings so High?"* (Chapter IV in *World Economic Outlook*, April 2006.)

⁹ TD Economics (2006). *Creating the Winning Conditions for Public-Private Partnerships (P3s) in Canada*, June 2006.

¹⁰ Statistics Canada (2003). *Public Infrastructure and the Performance of the Canadian Economy, 1961 – 2000*, a summary of 2 research papers.

pre-school program would increase U.S. GDP by about 3.5% per year and more than pay for itself through higher revenues.¹¹

In other words, *how* public funds are invested is just as important as *where* they are spent. For instance, *public* spending on health care per person is much higher in the U.S. than in Canada and most other OECD countries.¹² But the U.S. has considerably worse health care outcomes because the government subsidizes an expensive and inefficient privatized system.

Our government shouldn't just focus on competitiveness. What really matters is improving the overall quality of life of its citizens. The good news is that quality public services deliver both: a more competitive economy and a better quality of life.

t1/w1/cope 491
S:\Research\WPTEXT\ECONOMY\ECONOMIC BRIEFS\Taxes productivity.doc
September 6, 2006

¹¹ Dickens et al (2006). "The Effects of Investing in Early Education on Economic Growth" (Brookings Institute Policy Brief #153, April 2006.)

¹² OECD (2006). "Rising health costs put pressure on public finances, finds OECD" (*OECD Health Data 2006.*)