

CANADA'S VIRTUOUS CYCLE: A TRIUMPH OF CONSERVATIVE ECONOMICS?

Christopher Ragan



Canadian economic policy over the past 25 years appears to have been dominated by what might be called small-c conservative principles. Some might even argue that there has been a triumph. Is this true? Christopher Ragan from McGill University provides a five-point definition of conservative economics and then reviews the Canadian policy record since the early 1980s. He finds that while there has been a remarkable acceptance across the political spectrum of small-c conservative economic principles, ranging from monetary and fiscal discipline to skepticism regarding government ownership and regulation, it is too early for conservatives to claim a triumph. More work remains to be done, in particular in four broad policy areas.

La politique économique canadienne du dernier quart de siècle semble dominée par ce qu'on appelle le « conservatisme mou ». Certains vont même jusqu'à parler du « triomphe » conservateur. Est-ce vraiment le cas ? Christopher Ragan, de l'Université McGill, propose une définition en cinq points du conservatisme économique, puis il remonte au début des années 1980 pour dresser le bilan de notre économie. Il observe que ce « conservatisme mou » a fait l'objet d'un étonnant consensus sur tout l'échiquier politique, et constate qu'il transpire tant dans la discipline monétaire et budgétaire que se sont imposés les gouvernements, que dans la méfiance que suscite la propriété publique et la réglementation gouvernementale. Mais il est trop tôt pour parler d'un triomphe des conservateurs. Il leur reste beaucoup à faire, notamment dans quatre grands secteurs d'activité.

Listening to today's political discussions about economic policy choices, mindful of some of the contentious debates from the past 25 years, one can easily marvel at the evolution of thinking that has occurred. Many political sacred cows have been sacrificed and the economic agendas within political platforms have been significantly rewritten.

Consider just two examples. Debates raged in the mid-1980s over the problem of the national debt and the importance of reducing the annual budget deficit; today, all major federal political parties agree that the government's budget must avoid red ink. Next, the political fights over reducing inflation in the early 1980s and again in the early 1990s were considerable; today, no political party rejects the current objective of keeping the annual inflation rate close to 2 percent.

Looking back over these and other debates about economic policy, one might claim that Canada has witnessed a triumph of "conservative" economics. This article is

devoted to exploring the accuracy of such a claim. The focus here, however, is on what might be called "small-c" conservative economics as opposed to the specific policies advocated by the Conservative (or the Progressive Conservative) Party of Canada.

After a detailed definition of conservative economics, the highlights of federal economic policy over the past 25 years are reviewed. It is difficult not to conclude that there has been a remarkable success of conservative economics in Canada since the early 1980s, and that the central tenets of this brand of economics now seem to be accepted by the major political parties. As remarkable as this success has been, however, it is only a partial one. Additional key policy reforms are required before conservatives can claim a genuine triumph.

Defining "conservative" economics is necessary if we are to avoid merely semantic arguments. In the absence of

a single, authoritative source, conservative economics is here defined as a conceptual framework supported by five pillars.

To begin, at the heart of conservative economics is a general appreciation for the power of free markets. Economists often emphasize the effi-

The benefits of free trade are especially important in a country like Canada, which, though geographically immense, is very small in economic terms. For a broad range of goods and services, a firm producing purely for the small Canadian market is unable to achieve sufficient scale economies and thus unable to match the low costs attainable by larger foreign firms.

ciency with which free markets allocate scarce resources, and the general inefficiency associated with planned markets or other significant forms of government intervention. In contrast, non-specialists often emphasize the ability of free markets to adjust to changing circumstances, the incentives for innovation created by the existence of profits and the decentralization of power that exist in free markets. Both lines of argument are powerful and mutually consistent. Whatever the specific emphasis, there is an appreciation that free markets work remarkably well, and are often far superior to alternatives involving heavy doses of government intervention.

Naturally associated with this appreciation of free markets is a skeptical view of the benefits of government regulation of private companies and the direct government ownership of the means of production. This is not to say that regulation or state ownership is never consistent with a conservative economic view of the world; only that there is a general wariness of the often considerable costs associated with these forms of government activity. Regulators often become "captured" by the regulated firms, with the result that regulations once designed to benefit society eventually come to benefit the specific firms involved. State-owned enterprises are able in principle

to act in the best interests of society, but the absence of a profit motive often leads to tremendous inefficiencies that tend to be minimized by private, profit-seeking firms.

The second pillar of conservative economics is an application of the first, but is important enough to merit

separate mention. It is an appreciation for the considerable benefits of trade liberalization and the associated recognition of the high costs involved with the myriad forms of restricting international trade. The benefits of free trade are especially important in a country like Canada, which, though geographically immense, is very small in economic terms. For a broad range of goods and services, a firm producing purely for the small Canadian market is unable to achieve sufficient scale economies and thus unable to match the low costs attainable by larger foreign firms.

Access to the global market is therefore essential for many Canadian firms; but in the international arena of trade negotiations, access to foreign markets generally requires providing foreign firms with equal access to ours. In other words, free trade is important not only in providing our consumers access to the lowest-price products from other countries but also in providing our firms with large global markets. Both parts of this free trade arrangement lead to higher average living standards for Canadians: individual consumers who can purchase more with their dollars, and workers and entrepreneurs earning higher incomes from competitive production destined for international markets.

Fiscal discipline forms the third pillar of conservative economics, embodying a clear recognition of the problems created by large annual budget deficits and the accumulated government debt. Budget deficits imply public borrowing, and such borrowing tends to drive up market interest rates and lead to a strengthening of the domestic currency. The higher interest rates tend to "crowd out" private investment spending and the stronger currency tends to crowd out net exports. On both counts, the increase in government borrowing leads to a reduction in the private sector's ability to accumulate assets, with possible negative consequences for future economic growth rates. This is the long-term burden of government deficits.

The accumulated stock of government debt follows directly from past budget deficits. Even if the current budget deficit is small (or negative), a large stock of debt constrains government policy in real ways. High public debt — usually measured in terms of the debt-to-GDP ratio — can lead creditors to expect future inflation if they estimate that the government, with no alternative plan in place, will need to resort to the printing of new money in order to repay the debt. In addition, a high debt-to-GDP ratio generally means large debt-service payments for the government and an associated reduction in budgetary discretion. In other words, faced with the need to make considerable debt-service payments, the government may not have the capacity to increase spending or reduce taxes in an effort to stimulate the economy, should that possibility seem necessary.

For sensible economic conservatives, there is no need to always balance the annual budget or avoid government debt altogether. But there is nonetheless a clear recognition that debt can become too high, and that when this occurs fiscal policy must be

tightened until the debt-to-GDP ratio is reduced. Once this is accomplished, the same conservative perspective holds that budget deficits during challenging economic times should be roughly balanced by budget surpluses during good times, thus preventing further excessive accumulation of government debt.

The pillar of fiscal discipline includes a recognition that high marginal income tax rates can be very damaging because of the disincentives they create. High marginal tax rates on corporate profits provide a disincentive for investment in physical capital, which generally translates into less employment and lower wages for employees. High marginal rates on personal income can lead individuals to reduce their labour supply because the after-tax payoff from extra work is insufficient. This is not just a problem for high-income individuals; perhaps the most tragic case is that of low-income individuals who receive some form of social assistance but who would lose these benefits entirely if their earned income increased by only a small amount. Such individuals find themselves in a “poverty trap” created by the complex details of the income tax system.

Monetary discipline, with a policy objective of low and stable inflation, is the fourth pillar of conservative economics. Central to this objective is a clear recognition of both the power and the limitations of central banks and monetary policy. The desire for low and stable inflation reflects a belief that high inflation, along with its volatility, creates significant costs for consumers, workers and firms. These costs can be minimized by keeping inflation low; and inflation that is lower on average tends also to be more stable over time. Thus low inflation and stable inflation generally come as a joint product.

Recognizing the benefits from low and stable inflation, however, requires

neither a formal policy of inflation targeting nor a clear commitment to a flexible exchange rate. Low and stable inflation can be achieved in two very different ways. Several countries use a commitment to an inflexible inflation target and a simultaneous commitment to a flexible exchange rate. Other countries commit themselves only to maintaining a fixed exchange rate with some international currency, and need no inflation target whatsoever. These countries effectively “import” their monetary policy from abroad, and thus their commitment to low inflation is only as good as the commitments made elsewhere. Disagreements regarding the best approach certainly exist, and the often-technical arguments are sensitive to both time and place. But both approaches are consistent with conservative economics, which requires only the commitment to maintaining low and stable inflation.

The final pillar for conservative economics relates to social policy and is perhaps the most controversial of

particular, the approach they take is more likely to be one that reveals their appreciation for the functioning of markets and the importance of individual incentives.

Consider, for example, the important issue of poverty. Economic conservatives do not necessarily ignore this issue or think it unimportant. On the contrary, they may be as passionate about this issue as others who would describe themselves as anything but conservative. Yet in their assessment of the situation, they are more likely to recognize the various incentives and unintended outcomes created by existing policies, some of which are undesirable. In their search for better outcomes, they are likely to advocate newly designed policies that are less intrusive in labour and capital markets and more mindful of the incentives faced by individuals. A specific example is the long-time advocacy by Milton Friedman and other ardent conservatives of a negative income tax, a policy which explicitly

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those described here. Some commentators might argue that true economic conservatives generally ignore discussions of social policy, arguing that most policies of this type ought to be eliminated altogether and people left on their own to make private decisions. While one could certainly define conservative economics in this way, the result would be an excessive narrowing of the term with the result being that only a few percent of the economically literate population would count themselves in this group. It is more interesting to identify economic conservatives not as those people who ignore social policy issues but as those who take a specific policy approach to a given set of issues. In

transfers money to individuals but does so in such a way as to reduce marginal income tax rates and minimize the incidence of poverty traps, a problem alluded to above.

With the central tenets of conservative economics outlined, the stage is now set to review Canada’s record of performance since the early 1980s. Has there been a triumph of conservative economic policy?

There is no general measure of the degree of policy adherence to the concept of free markets, but some indication is provided by the level of regulation and state ownership. As occurred in several other developed countries at the time, especially the

United States and the United Kingdom, Canada embarked on a wave of privatization and deregulation during the 1980s and 1990s. The wave was largely initiated by the Mulroney Conservatives, but the Chrétien Liberals successfully maintained the policy momentum.

The move to lessen the level of government involvement in specific

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industries followed the growing recognition that such involvement not only was less effective than once thought, but had also become less necessary. The combination of technological changes, which made natural monopolies less frequent, and the ongoing reduction in communications and transportation costs, which lie at the heart of the process of globalization, worked to increase the degree of competition in many industries. The increase in competition naturally reduced, and in some cases eliminated, the need for government ownership or regulation. As a result, many Crown corporations were privatized, the most notable being Canadian National, Air Canada and Petro-Canada. Much deregulation also occurred, especially in the railway, airline, and gas and oil sectors.

The momentum for further policy changes, after slowing somewhat for several years, has increased again under the Harper Conservatives. In 2006, the Canadian Radio-television and Telecommunications Commission outlined the conditions under which it is prepared to fully deregulate local telephone markets. And just this year a new spectrum auction was conducted that will lay the groundwork for a substantial increase in competition in the wireless telephone market.

With the passage of the Canada-US Free Trade Agreement (FTA) in 1989 and its expansion to the North American Free Trade Agreement (NAFTA) in 1994, the second pillar of conservative economics was firmly established in Canada. The FTA was negotiated and implemented by the Mulroney Conservatives, as was the design of the NAFTA. The Liberals,

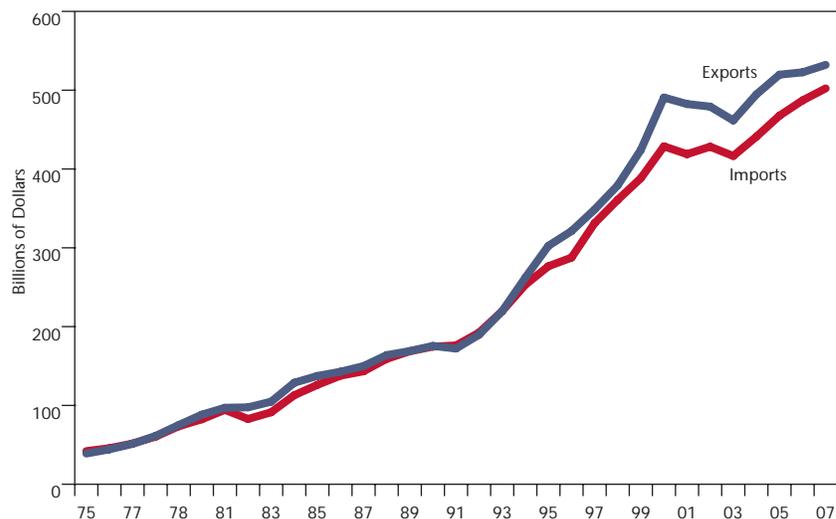
mining causality in economic relationships is always difficult, it is likely that the FTA and NAFTA agreements had much to do with the increase in Canadian trade, especially the large and growing share of trade with the United States. These greater trade flows allow Canadian firms and workers to be fully integrated into international supply chains.

Despite Canada's enhanced trading relationship with the United States, one can easily argue that its performance in developing other bilateral trade agreements has been disappointing, with only a handful of small agreements concluded in the past dozen years. In addition, one can lament Canada's lacklustre performance on the multilateral stage during the recent Doha Round of World Trade Organization (WTO) negotiations. Both of these criticisms of Canadian trade policy are valid. These criticisms, however, often miss an important point. For reasons of both history and geography, Canada's most important trading relationship — by a very large margin — is and probably always will be with the

under both John Turner and Jean Chrétien, argued against both trade agreements, but after their rise to power in 1993 they ensured that NAFTA came into effect. No political party today denies the importance of these agreements to the Canadian economy, and none speaks seriously of undoing them.

Canada's exports of goods and services now account for 35 percent of Canadian GDP (figure 1), up by 10 percentage points from 1988. (Imports are only slightly less.) Though deter-

FIGURE 1. CANADIAN EXPORTS AND IMPORTS, 1975-2007 (DOLLARS)



Source: Statistics Canada, National Accounts.

United States. The FTA and NAFTA may be the Canadian trade policies that really matter.

Fiscal discipline is the third pillar of conservative economics, and in this domain Canada has become the virtual poster boy for sound policy (figures 2a, 2b, 3). The initial moves against the federal budget deficit began under the Mulroney Conservatives, and that government made real headway in reducing what economists call the “structural deficit” — that part of the overall budget deficit dealing only with cyclically adjusted revenues and program spending (and excluding debt-service costs). While this structural deficit fell 5.5 percentage points of GDP during the Mulroney era, the overall deficit barely budged because of a rise in interest rates and a reduction in the economic growth rate. Under the Chrétien-Martin Liberals, however, continued reductions in the structural deficit were fortunately accompanied by an economic turnaround with lower interest rates and faster growth, and the result was a dramatic reduction in the overall deficit, from just under 6 percent of GDP in 1993 to a budget surplus of about 2 percent by 2005.

With large reductions in the annual budget deficit, and steady growth in the size of the economy, simple arithmetic guarantees a falling federal debt-to-GDP ratio. This ratio declined from just under 70 percent in 1997 to 32 percent today; the current Harper Conservative government is well on track to achieving its goal of a debt-to-GDP ratio of 25 percent by 2012.

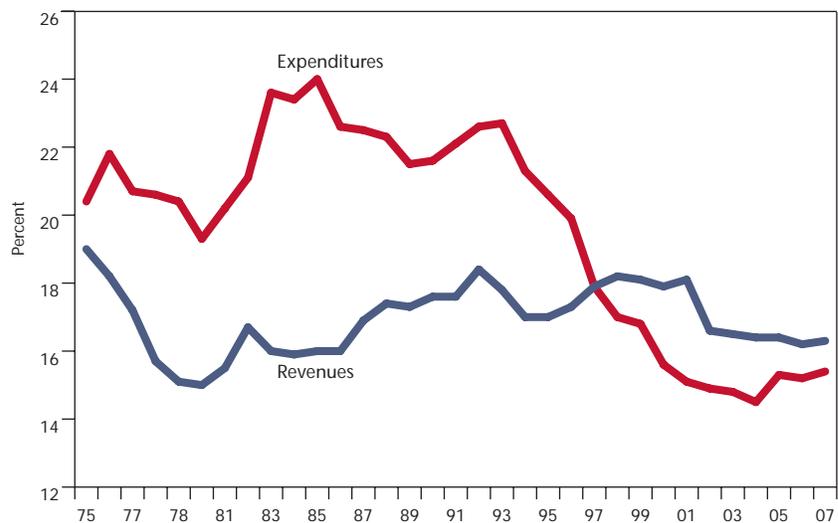
The benefits of Canada’s deficit and debt reduction — the “fiscal dividend” — have now become clear to most observers. With the dramatic decline in the debt-to-GDP ratio, the amount of the government’s budget devoted to debt-service payments has fallen considerably, and room has thus been made available for other forms of spending or tax reductions. The improved fiscal situation also pro-

vides the government with much more room to manoeuvre in terms of adjusting its spending or taxation in efforts to dampen the effects of the business cycle.

The policy objective of fiscal discipline clearly spread from the Conservatives to the Liberals, and these days one can easily be excused for not knowing which party has the strongest commitment to the concept. In addition, even the New

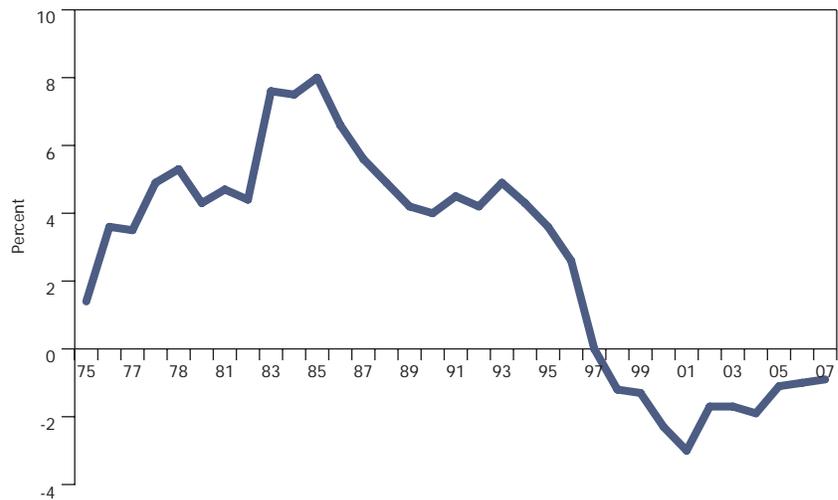
Democratic Party, which once argued against deficit reduction policies on the grounds that national debt was simply “money owed to ourselves,” now fully accepts the proposition that the federal government should avoid budget deficits. If anything, the mainstream Canadian political position has swung too far, with no party prepared to openly admit that there may be situations in which a small and temporary

FIGURE 2A. FEDERAL BUDGETARY REVENUES AND EXPENDITURES, 1975-2007 (PERCENT OF GDP)



Source: Department of Finance, Fiscal Reference Tables, September 2007.

FIGURE 2B. FEDERAL BUDGET DEFICIT, 1975-2007 (PERCENT OF GDP)



Source: Department of Finance, Fiscal Reference Tables, September 2007.

budget deficit might be acceptable, or even desirable.

The adoption of fiscal discipline was also accompanied by efforts at reforming the income tax system, efforts made especially by the Mulroney Conservatives. To begin, a growing concern over the damaging

Conservatives who have chosen to oppose conservative economic thought by reducing the GST, though surely more for reasons of political popularity than out of economic probity.

Canada has also become a poster boy with regard to its commit-

lower and more stable inflation, quite apart from the reduction in general economic uncertainty that high inflation typically injects into the economy, is what economists call the "anchoring" of inflation expectations. In a world with formal inflation targets, especially after the central bank

has credibly established its commitment to meeting them in a systematic manner, the private sector is much less likely to expect increases in future inflation as a result of significant economic shocks. For example, as the world price of a barrel of oil has

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effects of high marginal tax rates led to the 1987 reforms of the personal income tax system, with a reduction in the number of tax brackets and the top marginal rates. At the same time, greater efforts were made to better integrate the personal and corporate income tax systems. After the late 1990s, once the deficit had been tamed, both Liberal and Conservative governments continued the reforms by focusing on reductions in the corporate rate.

The most celebrated tax change, however, was unquestionably the replacement of the old manufacturer's sales tax with the goods and services tax (GST) in 1991. With the introduction of the GST, the Mulroney Conservatives put into practice a long-time conservative position that a movement away from taxing income and toward taxing consumption would remove an important disincentive to saving and thereby provide a stimulus to economic growth.

As efficient a tax as the GST is — few economists or tax policy specialists deny its merits — it quickly became the most hated tax in Canada, a notoriety it retains today. The Chrétien Liberals promised to do away with it during the 1993 election campaign, though upon coming to office realized that this was neither desirable nor easily possible. They have since become defenders of the GST; curiously, it is the Harper

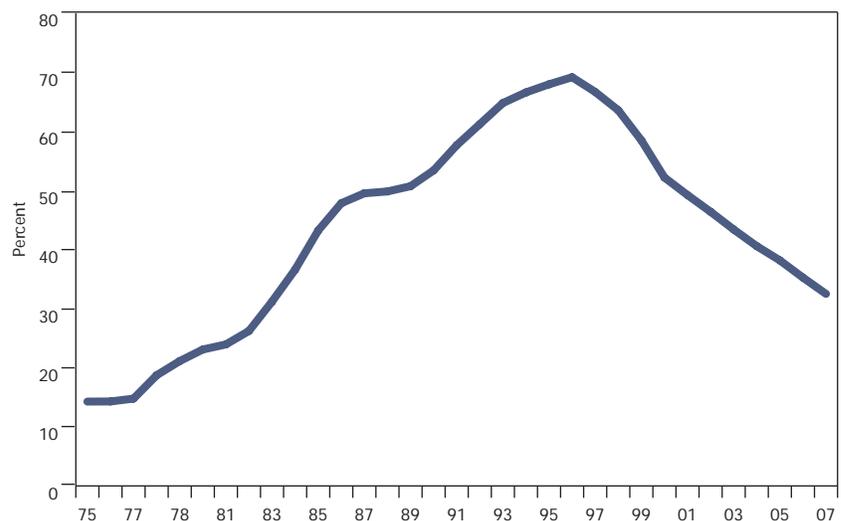
ment to monetary discipline, the fourth pillar of conservative economic policy. The first formal inflation targets, jointly agreed to by the Bank of Canada and the Department of Finance in 1991, were adopted by the Mulroney Conservatives and have been soundly in place ever since. For almost two decades, the annual rate of inflation has been much lower and more stable than was the case in the previous 20 years (figure 4), and the overall level of Canadian economic activity has been more stable as well.

One significant benefit from this

increased from US\$25 five years ago to over US\$125 today, expectations of future Canadian inflation have remained remarkably close to the Bank of Canada's target of 2 percent. Such stability of inflation expectations makes it easier for the bank to keep actual inflation close to target for the simple reason that it is inflation expectations that largely determine future wage increases, which in turn drive future inflation. Canada's system of inflation targeting is a genuine success.

Such a commitment to a formal inflation target requires an equally

FIGURE 3. CANADIAN FEDERAL NET DEBT, 1975-2007 (PERCENT OF GDP)



Source: Statistics Canada and Department of Finance, Fiscal Reference Tables, September 2007.

strong commitment to a fully flexible exchange rate. Perhaps the most important truth about monetary policy — typically misunderstood by non-specialists — is that central banks have only one policy instrument at their disposal. They can use this instrument to target inflation or to target (or even fix) the exchange rate, but they cannot do both simultaneously.

Some critics of Canadian monetary policy — especially those identifying themselves with the central Canadian manufacturing sector — argue that the Bank of Canada has shown an excessive commitment to its inflation target and insufficient concern for movements in the exchange rate. Particularly troubling to these critics was the dramatic appreciation of the Canadian dollar from 65 US cents in 2000 to par seven years later. (Tellingly, many of these same people appeared to be quite content with the substantial depreciation of the Canadian dollar which occurred in the late 1990s.) At the heart of this criticism, however, is either a lack of understanding of what monetary policy is able to do, or a belief that it is better to increase inflation for the entire country than to have some specific industries harmed by a strengthening currency.

It is surely the case that the dramatic changes in Canada's exchange rate over the past dozen years have created the need for painful adjustments in many sectors of the Canadian economy. It is equally true that these changes have been caused by real events, mostly international, ranging from changes in world commodity prices to a general weakening of the US dollar against all major world currencies. In the face of these changes, the Bank of Canada's determination in maintaining low and stable inflation reflects the understanding not only that changes in exchange rates are necessary (and desirable) in response to global economic events, but that the control of inflation is the most appropriate long-run objective for any central bank. That the bank's policy stance

has been so strongly supported by the various federal governments over the past 20 years suggests clearly that this same understanding has permeated Parliament Hill.

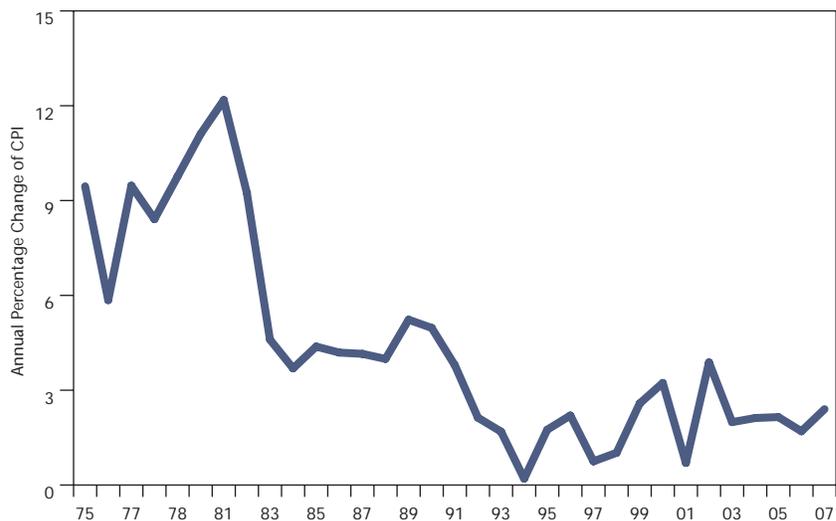
The final pillar of conservative economics is the design of social policy with a greater appreciation for the functioning of markets and the importance of individual incentives. This is undoubtedly the domain where conservative policies have made the fewest inroads over the past 25 years. For example, some modifications have been made to the employment insurance system that increase individual incentives for accepting appropriate job offers, yet the regional distortions embedded within the system remain, encouraging unemployed individuals to remain in regions with poorer job prospects. Many beneficial changes have been made to the income tax system, yet the overall tax-and-transfer system remains overly complex and highly distortionary, especially for low- and middle-income individuals.

Much Canadian social policy is delivered by the provinces, and thus it is necessary to say something about the provincial policy environment. But the lack of advancement in conser-

vative social policy is as true with the provinces as with the federal government. In terms of primary and secondary education, some reforms have been implemented allowing students greater school choice, but these have occurred only in Alberta. At the post-secondary level, though most provinces have increased tuition fees considerably, and some have allowed tuition fees to vary across programs of study, these changes can probably be explained more by tight provincial budgets than by a clear view that the system could benefit from genuine reform. In the realm of public health care, the provinces continue to muddle through with marginal changes to their respective systems, caught between the federal government's adherence to funding in support of the *Canada Health Act* and the growing recognition that careful increases in private sector involvement are likely to be a central part of any effective long-term solution.

Reviewing the overall record since the early 1980s, it is impossible not to detect a clear evolution of economic policy in the conservative direction. Whether it is the move toward less regulation and balanced budgets

FIGURE 4. CANADIAN INFLATION, 1975-2007



Source: Bank of Canada, PCPISA, all items.



MATIÈRE À RÉFLEXION :

« ON ESTIME QUE LES ÉMISSIONS
DE GAZ À EFFET DE SERRE RÉSULTANT
DE LA DÉFORESTATION CORRESPONDENT
À PLUS DE 18 % DES ÉMISSIONS
TOTALES DE GES. »

Rapport Stern sur les changements climatiques, octobre 2006

Compte tenu d'un taux de déforestation virtuellement nul et de plus de forêts vierges, de forêts certifiées et de forêts protégées que tout autre pays, le Canada est un chef de file de l'aménagement forestier durable depuis un certain temps déjà. L'industrie canadienne des produits forestiers s'engage à l'amélioration continue et elle souscrit à cette déclaration du Groupe d'experts intergouvernemental sur l'évolution du climat : « À long terme, la stratégie d'aménagement forestier durable qui vise le maintien ou l'augmentation des stocks de carbone en forêt, tout en assurant un rendement annuel soutenu en bois, sera la plus avantageuse en termes d'atténuation continue. »

Il est temps que le reste du monde suive
l'exemple du Canada dans l'aménagement durable
des forêts — le climat de la planète en dépend.



Association des produits
forestiers du Canada
fpac.ca

or the adoption of free trade agreements and inflation control targets, conservative economic policy has made great strides. Only in the realm of social policy has significant headway not been made.

Many of the successful conservative economic policies from the past 25 years were initially implemented by the federal (Progressive) Conservatives. It would be unfair, however, to claim that the federal Liberals played no more than a supporting role. In some domains, when faced with the opportunity to reverse already established conservative (and Conservative) policies, the Liberals chose to maintain them; the GST and NAFTA come immediately to mind. In other domains, notably that of the establishment of fiscal discipline, the Liberals arguably played the leading role.

More important than which political party deserves credit for specific policy initiatives, however, is how the political acceptability of these policies has changed. Despite the fact that each of the major policy initiatives reviewed above was immensely controversial at the time, today they all receive broad-based political support. Wholesale privatization of Crown corporations was controversial in the late 1980s and early 1990s, yet no political party today contemplates increasing government ownership in any significant way. The election of 1988 was fiercely fought (and won) on the advocacy of the Canada-US Free Trade Agreement, yet no party today proposes any significant actions to weaken or undermine the FTA or NAFTA. The politically difficult spending and taxation policies required to reduce the budget deficit generated an enormous amount of political heat at the time, yet today all parties seem to recognize the dangers of excessive public debt. The reduction of inflation in the late 1980s and the subsequent adoption of inflation control targets in 1991 led the political opposition

at the time to call for the firing of the governor of the Bank of Canada; almost 20 years later there is widespread support for the bank's central objective of maintaining low and stable inflation.

There has clearly been a remarkable evolution of Canadian thought regarding the most appropriate objectives for economic policy. The point is not that this policy evolution has been "appropriate" or "effective" or even "necessary," although one could easily make compelling arguments in this direction. The point is more objective: looking back, one can easily claim — independent of one's own political leanings —

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that the past 25 years in Canada have witnessed a significant rise in the influence of conservative economics.

Yet it is too soon for conservatives to claim a "triumph." For those individuals who believe the evolution toward more conservative economic policy has been both appropriate and effective, it is important not to become complacent with the status quo. Much important policy work lies ahead and must be completed before any genuine claim to such a triumph is possible.

Let's look at four important policy areas deserving of conservative-minded reforms: agricultural protection and multinational trade negotiations; continued tax reform to fight existing poverty; market-consistent environmental protection; and the elimination of "corporate welfare." This list could probably be lengthened, but even significant progress in these four areas would likely be enough for conservatives to claim their triumph.

The Doha Round of WTO trade negotiations is now seven years old, but progress has been very disappointing. At the heart of the talks is a quid

pro quo which, if achieved, would increase trade substantially and deliver benefits to rich and poor countries alike. If the rich countries, led by the United States and the European Union, agree to disassemble their agricultural tariffs and subsidies, the developing countries, led by China and India, will agree to open their domestic markets for industrial products. These negotiations have proved to be very difficult for many reasons, but chief among them are the remarkable political support that continues to exist in rich countries for farm-friendly policies and the desire on the part of developing countries to retain in their policy arsenal some of the same protectionist instruments the rich countries

used decades ago during the earlier stages of their development.

Given Canada's economic size, it is inevitable that Canada will not play a central role in these negotiations. Yet Canadian governments since 2001 have lost an important opportunity by coming to the negotiating table as, first, nothing more than a small developed country and, second, one with a logically inconsistent and hypocritical policy. Canada has steadfastly argued the need for reducing large agricultural subsidies in the United States and Europe on the grounds that such

subsidies tend to reduce world prices and thus hurt western Canadian farmers of wheat and other grains. Yet, at the same time, Canada has claimed that it must protect its current system of "supply management," which protects dairy, poultry and egg producers across the country. At times the Canadian position appears to be based on the belief that the quotas and extreme tariffs inherent in the operation of such supply management systems can exist without having any effect on the outside world. This bizarre negotiating position, clearly based on raw (and perhaps mistaken) political calculations, has damaged Canada's negotiating credibility and contributed to our marginal position at the WTO trade talks.

A consistent conservative position would recognize that it is time for Canada to sacrifice its supply-managed industries for the greater good — not only within Canada but also around the world. Canada could play a leadership role in the WTO trade talks as an "honest broker," working hard to bring the two sides together to deliver benefits to all. Yet a precondition for being an effective honest broker is to be honest; no country can expect to be taken seriously arguing against subsidies and tariffs out of one side of its mouth while arguing in support of quotas and tariffs out of the other.

Now consider tax reforms to fight poverty. Canada has made significant progress in reforming its tax system over the past two decades, with reductions in high marginal rates and the introduction of the GST being two notable examples. At the same time, however, Canada has retained its complex and confusing array of income support policies, ranging from employment insurance and social assistance to Old Age Security and the Child Tax Benefit. The overall motivation for such income support policies is not here in question, but an unfortunate conse-

quence of such a complex tax-and-transfer system is that the various policies often end up working at cross purposes. Particularly damaging are the "welfare traps" in which low-income individuals have little or no incentive to increase their earned income because of the transfers they would subsequently lose. Even though the combined (federal plus provincial) statutory marginal

Looking back, one can easily claim — independent of one's own political leanings — that the past 25 years in Canada have witnessed a significant rise in the influence of conservative economics.

income tax rates are now less than 50 percent for all income earners, the "effective" marginal tax rates are well in excess of 100 percent for a surprisingly large number of low- and middle-income earners.

Canada's tax-and-transfer system needs to be reformed to eliminate these poverty traps and thereby provide individuals with the appropriate incentives to work and save to promote their own best interests. A conservative approach to such reform can simultaneously recognize the damaging effects of poverty — to individuals as well as to the broader society — as well as the importance of designing policies which generate appropriate incentives. There will surely be disagreements about how best to proceed. For example, is it best to conduct a wholesale reform or can equivalent progress be achieved with a piecemeal approach? Should specific benefits be universal or should they be targeted to certain income groups? These are legitimate and sensible debates, yet the specific ways in which they are resolved may matter less than the overall project of placing the entire tax-and-transfer system under serious scrutiny.

A conservative economic agenda is based partly on recognizing the enormous and desirable role that can be played by relatively free markets. Yet sensible conservatives must also recognize that there are many situations in which free markets genuinely

fail. Environmental degradation is the obvious case of market failure, whether the problem is toxic waste in the water system, smog in our cities or carbon dioxide emissions leading to global climate change. In all cases, the fundamental problem is that the firms or consumers responsible for degrading the environment are not required to bear the full costs of their polluting actions for the simple reason that the

resources they use — clean air and clean water — do not have market prices. If markets existed for clean air and clean water, our environmental degradation would not be the problem it now is.

Global climate change is our biggest environmental challenge, and it is likely to be with us for some time. A central part of any effective solution must be the creation of markets for the environmental "goods" in a way which places a price on greenhouse gas emissions. There are several policy options, ranging from market-based policies such as emissions taxes and cap-and-trade systems to more direct forms of government control, such as vehicle emission and home-building standards. An important advantage of market-based policies is that they allow the pollution to be abated by those firms and consumers that can most efficiently do it, thus reducing the overall cost of any given amount of pollution abatement. But whatever policies are chosen, they are unlikely to be effective unless polluters face a clear and significant cost associated with their actions.

It is no surprise that Canadian policies in this domain over the past dozen years have been so ineffective (and that Canadian greenhouse gas emissions have thus increased so substantially), based as they were on encouraging *voluntary* actions by firms and consumers. A more conservative

and sensible approach would recognize the importance of individual incentives, and would thereby ensure that all polluters face significant enough costs for their actions that they will be induced to alter their behaviour. It now appears that Canadians will have an interesting debate between a carbon tax as pro-

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posed by the Liberals and an upstream cap-and-trade system as proposed by both the Conservatives and the New Democrats. This is not the place to discuss the pros and cons of each approach, but it is worth noting that both approaches would create costs for polluters and are well within the domain of conservative economic policy.

The fourth area deserving of conservative-minded reforms is that of “corporate welfare,” the plethora of government subsidies, grants, special tax holidays, loan guarantees and interest-free loans that Canadian governments at all levels continue to shower on Canadian firms. Recent estimates suggest that these gifts amount to roughly \$20 billion per year, one-third of which comes from the federal government. The motivation for such government generosity, aside from whatever political benefits might be generated, is usually the hope for employment and income creation.

The problem, of course, is that there is little or no evidence that corporate welfare generates any economic benefits whatsoever for Canada. Politicians will naturally claim that several hundred jobs will be created when a few hundred million dollars are given to some Canadian firm, but such claims reveal a deep ignorance of how labour markets actually work. It

may well be the case that the firms receiving the monetary gifts expand their operations and hire more workers, but these new workers must come from somewhere, and most of them come from a previous job at some other firm, perhaps in some other sector. So what appears as job “creation” to the politician is little more than a

redistribution of an unchanged number of total jobs.

A conservative-minded policy reform here must recognize the lack of economic benefits generated by such corporate welfare as well as the large opportunity costs associated with the billions of dollars spent. Whether the alternatives are tax reductions, debt repayment or more and better spending on education, health, defence or public infrastructure, Canadians would surely benefit from an elimination of this misplaced government (taxpayer) generosity.

The policy agenda sketched here is ambitious, and any future government that commits itself to making genuine progress in these four areas

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will face real challenges, both technical and political. Success requires policies to be designed with technical competence and creativity, especially so with the tax reform and environmental parts of the policy agenda. Success also requires the government of the day to make difficult political decisions, which really means implementing policies that are complex and

involve trade-offs between various groups in Canadian society. An essential part of the process is therefore communication: the government must be able and willing to explain the fundamental problem that needs to be solved, how a new policy would improve the situation and why the change is desirable for Canada and Canadians.

Those individuals who favour improved economic policies must fully recognize that good economics *can be* the basis of good politics — if only the effort

is made to explain more of the complex issues to the voting public. Honest and forthright public debates on difficult policy choices are an essential part of the process. This truth was well understood by the Conservatives during the 1988 electoral fight over free trade and also by the Liberals in the mid-1990s when fighting to reduce the budget deficit. In recent years, however, Canadian governments on both sides of the aisle appear to have fallen back on political expediency, choosing the politically easy road over the economically sound one.

A genuine triumph of conservative economics will require hard work and clear, honest communication with the Canadian people. This is surely

challenging, but it is possible and well worth the effort. Will any present or future Canadian government be up to the task?

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