

## Stop Calling the Kettle Black

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It takes all types to make the world go around. Some are born leaders. Others just seem to be in the right place at the right time. Unfortunately, far too many people make every effort to pass the buck. Those unwilling to fess up to their short comings have an annoying habit of calling the kettle black, attempting to blame others for their own failings. This paper is about all of that, and more!

## **CANADA SETS A POOR EXAMPLE**

While Canadians may have reason to be concerned about the mounting fiscal deficit in the United States, it would be wrong for us to point a finger. The latest OECD comparisons show that total U.S. government debt has never come close to the level of ours as a percentage of GDP. Furthermore, our tax and non-tax government revenues equal more than 40 percent of gross domestic product, the U.S. count slightly below 32 percent. What the U.S. gets as an offset for lower government receipts is greater growth, which it has consistently achieved over the past twenty-five years. Such goes a long way to offset the increase in its owing, and as a result U.S. government debt has remained well within a range consistent with its AAA credit rating.

In addition, the growth in the U.S. productivity rate has far exceeded Canada's, and seems destined to continue to outdo ours and that of much of the developed world's for the foreseeable future. One of the most important reasons why is capital investment, something they do much more of than we and most other countries do. It does not take a genius to realize that lower tax rates and a more dynamic business environment are two of the key reasons for the superior economic performance in the United States. If we persist in believing our salvation comes from a balanced budget, maintained by way of relatively higher tax rates, our faith is misplaced. Yet they and we would be better served by keeping tighter control of expenditures, and taxes in check. Raising taxes to offset a surging deficit and rising debt, as Canada has done, is not the way to the promised land. Should the U.S. decide to do as we have, they would end up enduring the very same economic malaise we suffer from. Therefore, the U.S. should avoid raising taxes, as lower government takes and spending cuts will ultimately produce the cash required to cover the fiscal deficit and the nearly U.S.\$9 trillion in federal debt, which amounts to about U.S.\$30,000 for every man, woman and child, as compared to \$500 billion, or \$15,362 (U.S.\$13,332) per person in Canada. We should also realize that it was dramatically lower interest rate costs on government debt which ultimately allowed Canada to achieve a balanced budget and a string of surpluses. It was not a cutback in superfluous spending by the federal

government. So rather than call the kettle black, we should think seriously about following the U.S.'s lead as a way to kick start Canada's productivity and the economy.

#### **THE U.S. TRADE DEFICIT IS NOT WHAT IT APPEARS TO BE**

The U.S. trade deficit rose for the fourth straight year, reaching a record U.S.\$728 billion in 2005. A record U.S.\$175.6 billion was for crude oil at an average price of U.S.\$46.78 per barrel which, by the way, had a very positive effect on the Canadian economy and the relative value of our dollar. Shipments from China hit a record U.S.\$202 billion, up from U.S.\$162 billion in 2004. Though there is little if anything the Americans can do to influence the price of crude oil, it is not surprising pressure is being applied to have the renminbi revalued in an attempt to make U.S.-made products more competitive and, thereby, reduce the growth in Chinese imports.

The United States is the world's most globalized country. Sweden ranks second by a wide margin, and Canada is third. Politically, economically and socially speaking, Japan is but fifteenth placed. Oddly, America's trade deficit has risen along with its globalization, and done so every year since 1970. However, according to Export Development Canada, the imbalance may not be all the problem others make it out to be, as a large percentage of U.S. international trade takes place within multinational companies dealing abroad with themselves. In 2003, these outfits imported U.S.\$530-billion worth of goods and services from their own operations and majority-owned subsidiaries in foreign countries. Within the same time frame, they exported U.S.\$314 billion to their businesses abroad. The net result was an "intrafirm" trade shortfall of U.S.\$216 billion – or 45 percent of the entire U.S. trade deficit of U.S.\$480 billion for that year. If one was to include transactions with other U.S.-owned companies and minority-owned subsidiaries, the trade deficit wrought through such trades rises to 70 percent. Furthermore, these dealings are self-sustaining and largely self-financed. The need for Americans to borrow money to accommodate this sort of trade deficit is minimal. The arrangements are also very profitable and, therefore, not a threat to either the U.S. dollar or the global economy. Companies increasingly care less and less about geography. Though patriot love may remain strong, international trade boundaries in the main are not. It is high time the more traditional economists, myself included, stopped calling the kettle black!

#### **A COMPLICATED BALANCING ACT**

Globalization makes it more difficult than ever before to find the right level of interest rates to foster solid economic growth, while keeping inflation at bay. Pushing them too high, or leaving them too low, could cost the North American economy dearly. Given the resilience of U.S. demand, the continued strength in China and emerging Asia, and the gathering momentum in Japan and the euro zone, international trade volumes will expand further in 2006. Economies are becoming increasingly dependent on one another as to raising living standards. One result is that central banks have less control over the cost of capital which was, heretofore, the primary tool used to help keep their economies running smoothly. With the world outside the United States awash in excess savings looking for a place to be invested, strong global demand for U.S. securities is one of the factors holding down long-term interest rates in North America. Overall, financial conditions are no more tighter now than when the Federal Reserve Board began raising short-term rates back in

June 2004. This implies that the credit markets apparently see less risk in lending to the U.S. government today than in years gone by.

Notwithstanding, much of the growth in U.S. demand for goods and services will inevitably be sourced from abroad, placing additional pressure on the trade deficit and the need for foreign capital to finance it. The threat of protectionism and a possible revaluation of the renminbi will effectively raise import prices. While foreigners have previously had reason to invest more than enough in U.S. stocks and bonds in order to prevent the U.S. dollar from tumbling, central banks about the globe are under increasing pressure to diversify their currency reserves. This change in strategy poses a real threat to the prospects for the relative value of the greenback. All of which will likely lead to a further increase in core inflation. This is the primary reason why the price of gold is on the rise and why the gold bugs are dancing in the streets. Whatever, the new chairman of the Federal Reserve Board will have a difficult time shaping monetary policy that is appropriate for an increasingly globalized U.S. economy. He has a complicated balancing act to contend with. Unless you have the answer, stop calling the kettle black!

#### **SOLVING CANADA'S FISCAL PUZZLE**

Using a new gauge of economic growth developed by the OECD, the Canadian economy outpaced its key industrialized rivals by a wide margin in the first half of 2005. It came within a stone's throw of matching China's furious, double-digit annual growth rate. Called "command" GDP, it provides a more complete picture by emphasizing purchasing power, instead of output. It also takes into account the terms of trade, or the price of imports versus the price of exports. This means that when the value of a country's currency increases, as Canada's has in recent years, its ability to buy imports climbs as does the gain from selling exports, and the effective growth rate accelerates. By this measure, our gross domestic product increased by 18.2 percent from the start of 2000 to the end of the second quarter in 2005, the U.S. by 14.2, Europe by 7.3, and Japan by just 5.1 percent. China is a major importer of high-priced commodities. Using the new method of calculating GDP its equivalent rate of growth was somewhat more modest than the 11.5 percent posted for 2005. What may be even more surprising is that our superior performance was achieved despite lagging gains in productivity. Let us all hope that relatively low interest rates, historically low unemployment, tame inflation, rising exports, soaring corporate profits, a possible double-digit increase in business investment, and strong domestic demand, will get and keep us on track to do even better in the future.

Throughout more than a decade in power the federal Liberals rarely saw a spending scheme they did not like, or they found ways to stash billions of dollars away in slush funds until they did. They never looked for a programme that might be cut or eliminated, nor considered the benefits of lower personal tax rates to increase take-home pay, or higher depreciation rates to spur on capital investment and productivity. Why the Liberal party leader Paul Martin, as minister of finance and subsequently as prime minister, was ever portrayed as being fiscally astute remains a mystery. The very suggestion that his Expenditure Review programme has plucked the low hanging fruit and there remains little that can be done to reduce government waste is preposterous. There is no escaping the fact that the Conservatives have many budget challenges to address. The first is to unravel their predecessor's spending record, and get a much better handle on wildly dysfunctional

federal operations. The fiscal imbalances, that the provinces rage about and Ottawa has so far refused to acknowledge, now top the federal-provincial agenda. The provinces' position is that the federal government should focus on its core responsibilities, instead of continuously looking for ways to intrude in provincial jurisdiction. Were this to happen, provincial politicians would become directly responsible for the tax dollars they raise and spend on health care, education, welfare, cities and highways, and much more. The federal government would lose its ability to impose national standards through equalization, a sadly cautionary parable about elected members with good intentions and faulty calculators. So it is going to take time and due consideration before Stephen Harper has his ducks in line and starts fiddling with the pieces of this three dimensional, five-decade-old puzzle.

Whether or not the Conservatives can squeeze an additional \$22.5 billion over five years out of the bloated federal system without incurring major restructuring costs, all the while fulfilling their election promises, only time will tell. In the meantime, it behooves the prime minister and the provincial premiers to come to their senses and stop being so stupid about paying out hundreds of millions of dollars a year attempting to shore up the traditional industries of agriculture, fishing and forestry, all money-losers on a stand-alone basis, and the Technology Partnerships Canada sinkhole for tax dollars, at the expense of profitable Canadian enterprises and hard-working individual taxpayers. There is no valid reason why the hewers of wood, and the many others who are drawers of subsidies, should continue to exist in their current form. Thousands of companies run into headwinds every year. They survive by adapting to change, and through innovation. As history has proven, those that live off government handouts never undergo the dramatic transformation needed to become truly successful. These days, there is nothing about the forestry industry that is not subsidized one way or another, yet we wonder why the Americans maintain limits on the importation of our softwood lumber. We are only kidding ourselves in thinking we are right and they are wrong. Until our governments fess up to and address the ineffectiveness of subsidies, the financial imbalance between Ottawa and the provinces, the provinces and the cities, will never be resolved. Sorting out the federal government's priorities will never happen until they do. It is time all politicians stopped calling the kettle black!

#### **THE PROVINCES AND CITIES HAVE CHALLENGES**

Ontario was once the most progressive province for business investment. It is now on the losing side of the competitiveness battle. While Ontarians are subjected to a plethora of explanations – the high-dollar troubles in manufacturing, unfair foreign competition, and unequal treatment by Ottawa – there seems to be little desire to look inward. Indeed, economically damaging policies implemented by the provincial government have contributed significantly to its woes. Fortunately, the road map to recovery is available and ready for the taking.

According to the Canadian Provincial Investment Climate Report, which uses empirical measures in seven areas of public policy, there is a substantial gap between the two leading jurisdictions – Alberta and British Columbia – and Ontario. In order to repair the damages and re-establish it as one of the more attractive venues for business investment in Canada, Ontario must reduce personal, corporate and capital taxes, improve the province's finances, promote investment in infrastructure, implement balanced labour laws, and dramatically reduce the cost of regulation.

In a similar vein, much of Quebec's relative underperformance is its own fault. In terms of investment climate, it now stands dead last, despite its lucrative research and development tax credits, cheap electricity, and competitive corporate taxes. Despite accounting for 21 percent of the country's GDP between 1999 and 2005, it received but 18 percent of the capital businesses invested in Canada. Less investment means less growth and, there too, Quebec's economy lags. Though doing a better job than other provinces in reducing the inequality between its rich and poorest citizens, it cannot be a champion in wealth redistribution for long without also winning medals for wealth creation. Even though one of the goals of open federalism is to address fiscal imbalances, a concept which has taken on almost mythical proportions in Quebec, *la belle province* must take responsibility for its own wealth or poverty if it ever hopes to solve its financial, economic and social problems. Its strategy should mirror that proposed for Ontario if it ever hopes to get back in the race and regain its long-lost lustre.

As to our major municipalities, rather than curtail spending or raise residential property taxes and user fees to resolve fiscal problems, civic leaders whine to the federal and provincial governments in the hope of having them pay for any shortfall. They willingly accept the strings attached to transfers from senior governments. Unfortunately, when push does come to shove many, fearful of offending the voters, revert to imposing higher levies on non-residential property which, in many instances, are well in excess of the services provided. Unfortunately, there is nothing to stop entrepreneurs from moving to lower tax venues and many that can do, often leaving nothing but inner-city slums behind. So the big-city mayors also need to suck it up and follow suit with what is being recommended for the provinces which are out of step in terms of gaining long-term investment capital, the primary driving force when it comes to creating growth, increasing the tax base, and the number and variety of better paying jobs throughout the community.

#### **CEOS HAVE AN IMPORTANT ROLE TO PLAY**

Thanks to a strong economy and a 50-percent surge in cash flow since 2000, Canadian corporations now sit on a cushion of \$280-billion worth of cash, foreign currency and short-term investments, which is increasing at the rate of \$60 billion a year. However, despite stagnant labour costs (except in the oilpatch and mining sector), our business leaders are only reinvesting 70 percent of these funds in what the economy needs most, productivity enhancing technology and equipment. With the robust growth in command GDP expected to continue, it should be 100 percent, and then some. Corporations have no right to pile up hoards of idle cash, assisted mightily by tax cuts, while renegeing on their economic responsibility to drive productivity higher. If the trickle-down theory of economics fails to take hold and make Canada a more competitive player on the world stage, governments are going to raise corporate taxes and, as we all know, that is the last thing we want to see happen. So CEOs must do as they should for sake of their investors and the country at large!

#### **IN CONCLUSION**

It is always easy to blame others when things go wrong or do not live up to one's expectations. However, the real winners in life know how to take a punch. They refocus their efforts and return to fight another day, and win. Calling the kettle black is never the right thing to do!