

# ARE BUSINESS SUBSIDIES EFFICIENT?

Although subsidies are often criticized for their undesirable economic effects and for the way they discriminate in favour of particular sectors or firms, they maintain a strong presence in our economy. Governments not only seem incapable of trimming them but tend to invest in new forms of business assistance that are subtler and harder to evaluate, leaving them less open to reproach. The concept of subsidies includes not only direct dollar transfers but also other forms of aid that do not involve actual disbursements or that are considered as investment rather than spending. While disbursements are easy to measure, other types of subsidy are merely implicit, and precise data on their extent are often unavailable.

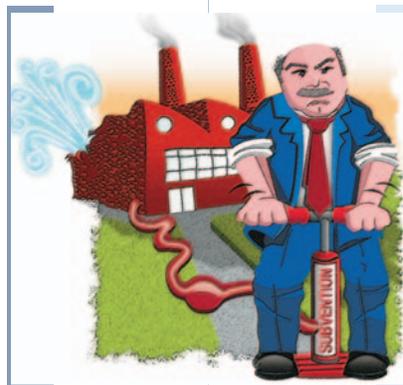


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## The various types of subsidy

Subsidies to business fall into several categories.<sup>1</sup>

► Direct subsidies, as in unconditional or conditional transfers. A transfer is defined as a payment with no good being provided or service rendered in exchange. Unconditional transfers involve sums of money that a company receives as long as it remains active, whereas conditional transfers more closely resemble a type of loan. The latter are often called contributions. For example, contributions from the federal government's Technology Partnerships Canada (TPC) program are reimbursed if projects are profitable.



► "Tax expenditures" are tax advantages (exemptions, deductions, lower tax rates, refundable or non-refundable tax credits, etc.) in comparison to the general tax structure, favouring certain types of activity or certain types of business. They may be considered as subsidies to the extent that, in their absence, the government could have collected the same amount of revenue with lower tax rates for all companies.

► Interest-free or low-interest loans or credits are another form of subsidy used to finance companies. With interest-free loans,

the subsidy matches the interest income the loan would bring in if it had been invested over the same period in a genuinely profitable venture. This opportunity cost includes a capital loss (more specifically, the anticipated losses on all loans of this type) if a company cannot refund the loan, as occurred, for example, with the Gaspésia paper mill project to which Investissement Québec had loaned nearly \$70 million in

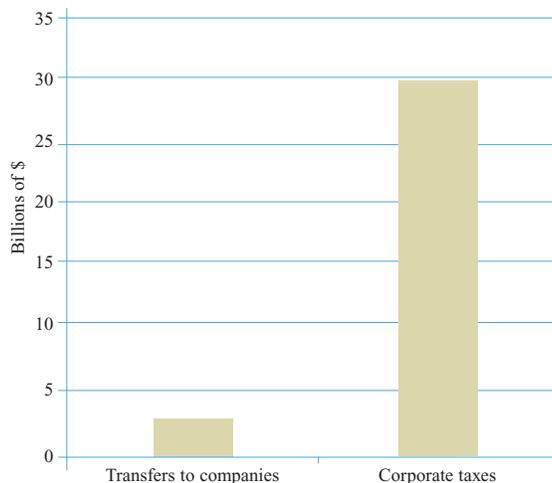
taxpayers' money.<sup>2</sup> With interest-bearing loans, the effective subsidy is equal to the difference between the requested interest rate and market rates.

► Loan guarantees provided, for example, by Investissement Québec or Export Development

Canada (EDC) to foreign purchasers of aircrafts produced here are also a form of implicit subsidy. Through these subsidies, government bodies guarantee to a private borrower that loans and interest will be refunded either by the subsidized firm or, in the event of bankruptcy, by the government bodies themselves. Thanks to this guarantee, the company gets a lower interest rate than it would have obtained on the market. The subsidy corresponds to the loss provision that the government sets up to cover non-refunded loans.

1. For a synthesis of the various forms of subsidy, consult Neil Bruce, "Measuring industrial subsidies: some conceptual issues," OCDE Working Papers, No. 75, February 1990, available at <http://www.oecd.org/dataoecd/15/63/2002595.pdf>.  
2. See the Commission d'enquête sur la Société Papiers Gaspésia, *Rapport sur les dépassements de coûts et de délais du chantier de la Société Papiers Gaspésia de Chandler*, Quebec City, May 2005, available at [http://www.mdeie.gouv.qc.ca/page/web/portail/developpementRegional/service.prt?page=details.jsp&iddoc=63765&svcid=QUOI\\_DE\\_NEUF8](http://www.mdeie.gouv.qc.ca/page/web/portail/developpementRegional/service.prt?page=details.jsp&iddoc=63765&svcid=QUOI_DE_NEUF8).

**FIGURE 1**  
**Transfers to companies and corporate taxes,**  
**Government of Canada, 2004-2005**



Source : Government of Canada, *Public Accounts of Canada 2004-2005*, Vols. II and III, Ottawa, 2006.

► Financial involvement in a commercial company through shares or units, as engaged in by Investissement Québec or the Société générale de financement (SGF). This is generally undertaken under conditions that are more favourable to a subsidized commercial company than would be the case if it had to attract private involvement on capital markets. For example, it may not be required to pay dividends to the government the same way it would with private investors.

► There are also other non-monetary assistance such as consulting services from the Quebec Department of Economic Development, Innovation and Export Trade, protectionist privileges and price supports in the agriculture sector, preferential electricity rates for aluminum smelters in Quebec, and so on. In the same way, employment insurance for seasonal workers in Canada could be considered an implicit subsidy. The OECD notes that in Canada “the federal Employment Insurance (EI) system reduces labour mobility and cross-subsidises firms heavily reliant on seasonal workers.”<sup>3</sup>

## Federal subsidies

In overall terms, direct transfers from the federal government to businesses totalled \$3.3 billion in 2004-05, of which \$1.5 billion (45%) went to companies outside the agriculture and food sector.<sup>4</sup> To put these data into perspective, we should note that subsidies to non-agricultural and non-food businesses came to 0.7% of the federal government’s budgetary spending and federal corporate taxes are nine times as high as total subsidies to companies (see Figure 1). It should be entirely possible to cease giving with one hand what is being taken away with the other hand and to reduce subsidies, assisting companies through a reduction in their tax burden.

Federal subsidies to companies come mostly from the Department of Industry and from bodies that subsidize regional development and native peoples.<sup>5</sup> Transfers from the Department of Industry are concentrated in the TPC program, which subsidizes R&D spending. In 2004-05, \$305 million in contributions were paid to 31 companies. Although these contributions are refundable if the specific ventures turn a profit, an investigation conducted by the government in 2003 revealed that most of the refunds due were not paid.<sup>6</sup> The “portfolio” of TPC contributions had thus climbed to \$2.1 billion as of March 31 2005; in the fiscal year ending on that date, only \$38.2 million was refunded.

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The Department of Industry also administers the Canada Small Business Financing (CSBF) Program, which refunds part of the losses shown by financial institutions that lend to beneficiary companies. In 2004-2005, \$88.7 million appeared in the public accounts to finance these losses. Loans and loan guarantees to companies from federal bodies represent several billion dollars in

3. OECD, *Economic Policy Reforms: Going for Growth 2006*, Paris, 2006, p. 25.

4. See *Public Accounts of Canada 2004-05*, available at <http://www.pwgsc.gc.ca/recgen/text/pub-acc-e.html>.

5. See Table 1 in the appendix to this Economic Note on the MEI website at [http://www.iedm.org/main/show\\_publications\\_en.php?publications\\_id=138](http://www.iedm.org/main/show_publications_en.php?publications_id=138).

6. Audit and Evaluation Directorate, *Audit of Technology Partnerships Canada*, Industry Canada, October 2003.

potential future liabilities. As of March 31, 2005, this included \$874 million for loan guarantees to small companies and \$2.7 billion for EDC loan guarantees.<sup>7</sup>

To these amounts must be added subsidies consisting of federal tax credits to companies and of investments in state-owned corporations that finance business. For example, in 2004-05, the federal government purchased \$250 million in new shares of the Business Development Bank of Canada, which offers financing to small and medium enterprises.

### Quebec subsidies

In 2004-2005, the Quebec government paid \$984 million in transfers to business.<sup>8</sup> This equals 1.7% of total government spending and is less than one-quarter of corporate taxes.

Some 41% of transfers go to companies in the agriculture, fishery and food sectors, indicating yet again the weight of these sectors in government subsidies.<sup>9</sup> One-fifth of subsidies to companies other than those in the above sectors (11% of all subsidies to business) are intended for economic development, regional development or research. The remainder largely benefits companies providing social and cultural services: child-care centres, ambulances, culture and communications.

To these data must be added \$1.1 billion in refundable tax credits, in particular for R&D (52%) and film production (10%)<sup>10</sup> as well as future liabilities from loans and loan guarantees. For example, Investissement Québec, the main vehicle for business aid, handles assistance operations each year in the form of loans or loan guarantees equivalent to 10 times its annual transfers of \$84 million (in 2004-05).<sup>11</sup> Quebec as a society has thus accumulated a \$3.3-billion portfolio (as of March 31, 2005), including a \$157-million provision for losses on guarantees.<sup>12</sup>

These data include subsidies distributed by various regional economic development bodies, but not their operating expenses.

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Moreover, they do not include prior government capital ownership in the Innovatech venture capital funds, nor the reduction in this capital through annual losses. Between 2004 and 2005, Innovatech funds ran up \$109 million in losses.<sup>13</sup>

### The economic effects of subsidies

Subsidies, in whatever form they take, create distortions in normal market operations. Through subsidy programs, governments are deciding to favour a company, production or sector artificially. This generates a cost for other, more profitable projects and for the production of other goods and services that represent greater value in the eyes of consumers and that may have been chosen in the absence of subsidies.

Subsidies always bring about a “malinvestment.” This results from the fact that economic resources are diverted from their most profitable use and are no longer available to be invested elsewhere in the economy. Taxpayers are forced to bet cash on the potential success of risky subsidized projects, as determined by politicians and civil servants for reasons that may depend more on political than on economic value.

Furthermore, the existence of subsidies gives rise to “rent-seeking” activities to obtain them. Instead of seeking to be more competitive or to satisfy consumers, business people have to waste time and resources to be sure of getting subsidies from public authorities. Their survival is all the more dependent on this since they must support a heavy tax burden, made heavier by the existence of subsidies.

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7. *Public Accounts of Canada 2004-05*, Vol. 1, Table 9.8, p. 9.13.

8. Data in this section come from the Quebec Government's *Public Accounts 2004-2005*, available at <http://www.finances.gouv.qc.ca/fr/documents/publications/cp-2004-2005.asp>.

9. See Table 2 in the appendix to this Economic Note on the MEI website at [http://www.iedm.org/main/show\\_publications\\_en.php?publications\\_id=138](http://www.iedm.org/main/show_publications_en.php?publications_id=138).

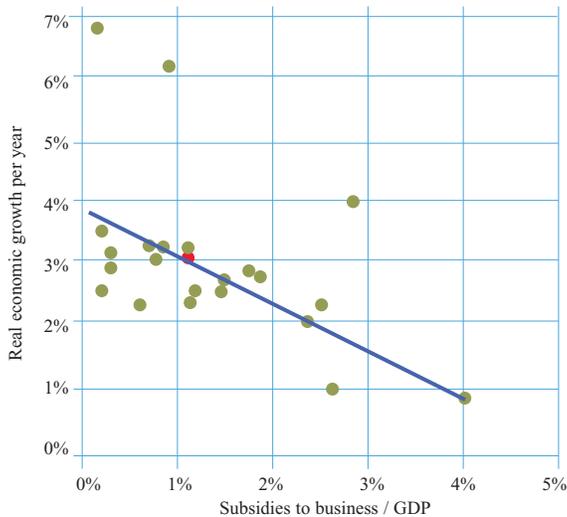
10. *Public Accounts 2004-2005*, Vol. 1, p. 58.

11. Investissement Québec, *Annual Report 2004-2005*, pp. 18 and 21.

12. *Ibid.*, p. 11.

13. *Public Accounts 2004-2005*, Vol. 1, p. 87.

**FIGURE 2**  
**Business subsidies as a proportion of GDP and real economic growth in OECD countries, 1970-2004\***



\*\*Each dot on the graph represents a country, with the red dot identifying Canada. The period is shorter for countries with incomplete data. The numbers are averages for the entire period.

Source: *National Accounts of OECD countries*, available online at Source OECD ([www.oecd.org](http://www.oecd.org)).

Subsidies in the form of direct transfers, loans or loan guarantees also have the drawback of penalizing performance. Money is confiscated from top-performing businesses, among others, to be redistributed and invested in less profitable – or unprofitable – ventures.

This also applies to refundable tax credits, which are paid even when a company is not paying taxes. In contrast, non-refundable tax credits – which companies can deduct only from their taxes, with no possibility of receiving government money if they have no taxes to pay – have the advantage of being a far less harmful

form of subsidy and of leaving money with its owners, who earned it by creating wealth. Moreover, to the extent that tax credits are available to all companies, or to many of them, they are less discriminatory and cause fewer economic distortions or inefficiencies. They can be seen as a way of reducing the overall tax burden. For all these reasons, non-refundable tax credits are preferable to other types of subsidies. However, general tax reductions would be even more useful.

Subsidies end up reducing business efficiency and wealth creation. Though governments justify them on the grounds that they promote economic growth, no such link has been proven. As shown in Figure 2, the greater a role that subsidies play in an economy, the lower economic growth seems to be. There may thus have been a negative relationship between direct subsidies and economic growth in

OECD countries between 1970 and 2004. Other econometric studies confirm that subsidies, at best and only in certain cases, have no effect on economic growth and that the size of government, which grows with the provision of subsidies, has a negative effect on economic growth.<sup>14</sup>

Subsidies are inefficient but hardy. They pop up in hugely varied forms but always have undesirable effects that harm economic performance. Rather than create new assistance programs, governments in Canada should be lowering the tax burden on all businesses.



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Printed in Canada

Illustration:  
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Graphic Design:  
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14. See Karl Aiginger and Martin Falk, "Explaining Differences in Economic Growth among OECD Countries," *Empirica*, Vol. 32 (2005), pp. 19-43; and OECD, *The Sources of Economic Growth in OECD Countries*, Paris, 2004.