

WITH NIELS VELDHUIS, SENIOR RESEARCH ECONOMIST, THE FRASER INSTITUTE



Niels Veldhuis is Senior Research Economist at The Fraser Institute. Since joining the Institute in 2002 he has authored or co-authored 10 comprehensive studies on a wide range of topics including, taxation, labour markets, government debt, government failure, fiscal discipline, and economic prosperity. Mr. Veldhuis is also the primary researcher for Tax Freedom Day. He has written over 50 articles, which have appeared in some 20 newspapers across the country. He has appeared as a commentator on various radio and television programs. Mr. Veldhuis received a Bachelor degree in Business Administration (1999), with joint majors in business and economics and a Master Degree in Economics (2001) from Simon Fraser University. He was interviewed after his presentation on Manitoba's size of government at the Frontier Centre on March 11th, 2005.

Frontier Centre: How much larger is Manitoba's government sector than the Canadian provincial average?

Niels Veldhuis: Much larger. Federal, provincial, and local government spending in Canada equates to 38 percent of GDP; in Manitoba, total government spending represents 47.5 percent of GDP.

FC: Does that include Crown corporations like public auto insurance and Hydro?

NV: Payments by governments to Crown corporations when Crowns do not cover their costs and record a deficit are included.

FC: Does the size of government matter? What is the relationship between the size of government and economic performance?

NV: There is a growing body of research supporting the idea that the size of government matters with respect to economic performance. That is, there exists an optimal level of government which maximizes economic growth. Most of the research indicates that increases in the size of government beyond the optimal level results in lower rates of economic growth.

FC: A recent report by the Canadian Centre for Policy Alternatives states that public services are collapsing in Manitoba due to a tax cut obsession. They claim provincial government spending declined from 18.9 percent of GDP in 1995/96 to 17.9 percent in 2002/03. What is your view on this?

NV: First, the CCPA report relies on budget data while we rely on data from Statistics Canada, which is in general more comprehensive. Also, the CCPA uses only provincial spending rather than including both provincial and local government spending. From 1989/99 to 2003/04, the range for which comparable data exists, the size of the provincial and local government has decreased from 31.7 percent of GDP to 30.5 percent, which hardly equates to a collapse. In addition, when federal spending is added, the size of government is well above that which would maximize economic growth. Finally, using a percentage of GDP as a metric means that government spending could increase by 25 percent, but so long as GDP growth is higher, the size of government relative to the economy will be shrinking.

FC: If Manitoba's economic performance is so mediocre, why do we have one of the lowest unemployment rates in Canada?

NV: One of the key reasons Manitoba has low unemployment rates is a result of the out migration of workers, especially the young. In the past 10 years, Manitoba has had a net outflow of over 37,000 individuals.

FC: So it is nothing to be proud of?

NV: No. The consistent out-migration of workers is worrisome and not something that can be sustained over the longer term.

FC: Doesn't the equalization system reward Manitoba for having a bigger government?

NV: Equalization certainly takes away part of the incentive to have reasonable tax rates and other policies that promote economic growth.

FC: Where should we start fixing the problem - with tax cuts on the revenue side or with service cuts on the spending side?

NV: Going forward, the least painful way to create the fiscal room needed to implement tax relief is to control government spending. That is, Manitoba should hold spending to inflation plus population growth.

FC: If we look at the recent federal budget and the recent provincial budget, we have spending exceeding that. What are the consequences?

NV: One obvious consequence is that it doesn't leave much room for tax relief. The federal budget had a 12 percent increase in spending this year, which is double the rate of economic growth. This is simply not sustainable. In Manitoba, government spending is growing faster than inflation plus population and leaving little fiscal room for tax relief.

FC: If you had to reduce taxes, are there particular taxes that should be reduced first?

NV: Absolutely, tax relief should be focused on improving the incentives for work, savings, investment and entrepreneurialism. These are the backbone of a prosperous society. Specifically, Manitoba must completely eliminate the corporate capital tax, reduce the general corporate income tax rate, and address the middle and upper personal income tax rates and the thresholds at which they apply.

FC: In the recent provincial budget, the government announced that it was cutting the

middle tax rate. This sounds good to most people. What is your view on that?

NV: I certainly welcome tax relief and reductions in the middle tax rate are needed. In fact, Manitoba desperately needs both middle and upper tax relief, as the rates are relatively high and they apply at low levels of income. For instance, the top rate in Manitoba is currently 17.4 percent. In addition, it applies at a low level of income -- \$65,000. If you look across the western provinces, the top income tax rate is 15 percent in Saskatchewan and applies to income above of \$103,000, is 14.7 percent in B.C. and applies to income above 90,000 and Alberta has a single rate of 10 percent.

FC: With Alberta having much lower taxes, what does it mean for business investment in Manitoba?

NV: High effective tax rates on capital leads to lower rates of business investment. It's Economics 101: make something more expensive and you'll get less of it. This is exactly what we see in Manitoba.

FC: In Manitoba there is a lot of capital spending happening within the public sector. Is this a good thing?

NV: The difference between public sector and private sector capital spending is important. We have to remember that governments are preoccupied with fulfilling social rather than economic goals. This often leads to the misallocation of resources. In other words, governments do not allocate capital to where it garners the highest economic return. This has both short- and long-term consequences for the functioning of an economy.

FC: The largest provincial spending envelope is health care. How can we bring our spending in line when its terms and conditions are set in Ottawa?

NV: We need some way of reducing the cost pressures on health care and one of the easiest ways to do that is to introduce competition. Introducing competition will make hospitals more efficient, leading to better outcomes and more satisfied customers.

FC: What will it take to convince the public that private provision or competitive provision of health services will help Medicare and not hurt it?

NV: I think the exact type of work that the Fraser Institute and the Frontier Centre do. That is, to show people what works in other countries. Many other countries that have well functioning public health care systems also have private sector involvement.

FC: What is the optimum size of government?

NV: The research that has been done for Canada indicates that historically the optimal size of government has between 20 to 30 percent of GDP.

FC: Where are we now both nationally and in Manitoba?

NV: In Manitoba the government spending represents 47.5 percent of GDP, which is well above the 30 percent threshold. Nationally, we are at 38 percent.

FC: In your presentation, you mention the phenomenon that, if you reduced government spending, we would increase economic growth. Some people have a problem making this connection. Could you explain it?

NV: Higher levels of government spending relative to the economy results in higher tax burdens. Higher tax burdens, as we talked about earlier, impedes economic performance by punishing hard work, risk-taking and investment. Thus, reducing government spending relative to the economy will allow us to reduce Canada's relatively high tax burden.

FC: So reducing spending can actually be a positive?

NV: Yes, it's what's known as the virtuous circle. Reducing spending allows for incentive-based tax relief that results in economic growth. A larger economic base is able to generate more revenue. So a smaller government relative to the economy can lead to increased revenues for government. Take Alberta as an example. It has the smallest government sector relative to the economy at yet its level of per person spending ranks fourth in the country.

FC: Do have any examples of where government spending has been cut and, at the end of the day, everybody is better off?

NV: There are two great Canadian examples, Alberta and Ontario. Both these provinces went through reductions in real spending in the early and mid-nineties. Spending reductions were needed to balance government books and provide room for tax relief, which lead to increased economic growth.

FC: What is the most important step we could take in Manitoba to ensure competitive labour markets?

NV: Reforming labour relation laws. Manitoba has some of the most rigid and prescriptive labour relation laws in North America. A growing body of academic research supports the view that rigid and union-biased labour laws discourage economic activity and reduce business investment.

FC: If you had to give us two or three items specifically, what would they be?

NV: First would be the introduction of worker choice laws or what in the United States are referred to as right-to-work laws. These laws give workers a choice with respect to whether or not to join a union and remit full dues. Second would be to reform certification and decertification rules. Manitoba's certification and decertification process is the most unbalanced and pro-union in North America.