

WITH Niels Veldhuis, Senior Research Economist, the Fraser Institute



NIELS VELDHUIS is Associate Director of Fiscal Studies and Senior Research Economist at The Fraser Institute. Since joining the Institute in 2002, he has authored or co-authored three books and 17 comprehensive studies on a wide range of topics including, taxation, productivity, entrepreneurship, labour markets and government failure. The author of more than 90 articles which have appeared in over 30 newspapers including the *National Post*, the *Globe and Mail* and the *Wall Street Journal*, he appears regularly on radio and television programs across the country and has appeared before committees of both the House of Commons and the Senate as an expert witness. Veldhuis holds a Bachelor's degree in Business Administration, with joint majors in business and economics, and a Master's Degree in Economics from Simon Fraser University. He was interviewed following a speech to a Frontier breakfast on March 2, 2007.

Frontier Centre: When we last spoke two years ago, you shared numbers showing that Manitoba's public sector was much larger than the Canadian average. Has anything changed?

Niels Veldhuis: No, unfortunately not. If you add up federal, provincial and local spending, the total size of Manitoba's government relative to the overall economy is 50%, which remains one of the highest proportions among Canadian provinces.

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

NV: That's an important question, and I urge people to go to the Frontier Centre's website and look at my 2005 presentation on the subject. A lot of academic research has been done on a whole host of economic and socio-economic indicators that relate to the size of government, defined as government spending relative to the economy. Those indicators include Gross Domestic Product (GDP), employment growth, healthcare outcomes, education outcomes and life expectancy. All of these academic studies show that there exists what's known as an optimal size of government and in Canada that's somewhere between 20 and 35% of the GDP.

FC: Why are there differences in those estimates? Late last fall, we hosted Richard Vedder from Ohio State University, and he says the optimal level is 17.5%. Why are your numbers so high compared to his?

NV: I'm well aware of Richard Vedder's work and he is on the forefront of this sort of research. One of the reasons for the disparity is differences in jurisdictions. In places like Canada, where you have bigger gaps between the population, infrastructure and those sorts of things require more money, so you're going to get a slightly higher optimal size of government. In places with quite a dense population, it might be a bit lower

because obviously you don't have to provide the level of infrastructure that you do in Canada, where we have vast tracks of open land.

FC: One of the differences in the economic performance of Manitoba that is often overlooked is the fact that we have the highest aboriginal population. Because of special circumstances of law on reserves that negatively impact economic outcomes, that demographic fact drags down our performance and our indicators. How does that affect Manitoba's standing in the overall numbers?

NV: That may have an impact. It's not something I have looked at very closely. But it's all about creating the right environment. That applies to the general population and it certainly applies to the aboriginal population. The Frontier Centre has done good work in trying to make people aware of what policies are needed in those jurisdictions to create the right environment for people to join the "prosperity party."

FC: Saskatchewan has an NDP government that, at least on the subject of tax competitiveness, seems to have gotten the message. Manitoba's tax cuts have been niggling in comparison. Is it inevitable that the next domino is Manitoba?

NV: If you're living in Manitoba, you would certainly hope so. Saskatchewan finally received the message last year and enacted major business tax reforms in its 2006 budget. I personally hope that Manitoba's next and joins in what the other western Canadian provinces are enjoying, which is prosperous economies. If Manitoba does want to join that club, it has to reduce its business taxes and its corporate income taxes dramatically, and it has to eliminate its most damaging tax, the corporate capital tax.

FC: How badly is Manitoba lagging the rest of Canada in terms of its economy? Is the divide growing? Are we getting worse relative to other provinces?

NV: In terms of economic performance, Manitoba certainly ranks among the worst provinces, along with Atlantic Canada, in terms of GDP per capita and disposable income per capita. It has one of the worst records, perhaps even the worst record in terms of private-sector job creation.

FC: One of the crucial indicators you discussed today was our low investment levels. Why does that matter?

NV: Unfortunately, Manitoba does have a relatively low level of investment relative to the other Canadian provinces. We know that when you have low levels of investment, workers are less productive and, when workers are less productive, their wages are lower. So it's a ripple-down effect. If you create the right environment and get increased investment, you are going to get higher rates of productivity and you're going to get better wages for Manitobans.

FC: In your talk today, you spoke of two approaches to economic development. Can you summarize what you said?

NV: The first one is creating the right environment, one which gives people the incentives to participate actively. That means giving people incentives to work, to take risks, to save their money, to invest their money and to act entrepreneurially. The way that you do that is by having an optimally sized government, a competitive tax regime with incentive-based taxes – which translates into lower taxes on personal income and businesses, the most damaging types of taxes – streamlined regulation and free trade.

The second way is to have an actively managed economy, where the government is heavily involved (as in Manitoba at 50%), where the government favours certain industries and subsidizes and provides tax credits to certain industries, where trade is not free, where you have more damaging regulations on one industry relative to another and where you have a lot of red tape in the economy. One has the government actively involved in trying to create prosperity – which seldom results in a prosperous economy – and the other is creating the right environment.

FC: What is the new inter-provincial trading arrangement between B.C. and Alberta? Is there any momentum for expanding it throughout Canada?

NV: The Trade Investment Labour Mobility Agreement (TILMA) is an historic agreement signed by B.C. and Alberta in 2006. It basically creates one large

economy between the two provinces. By 2009, you will have free movement of goods and services, people and investment. So if you are a registered teacher in one province you can automatically teach in the other. If you are a tradesperson in one province, you are automatically registered in the other. The same applies for business licensing. It's going to result in a much more dynamic economy because people, labour, goods and services are able to move across borders freely.

There are rumors going around about other provinces looking at this. I think this is a huge opportunity for Manitoba. If Manitoba were the third province to sign on to this agreement I think the ramifications would be very beneficial for Manitobans.

FC: We'd have to swallow some pretty severe changes. Some autarchic practices you described today would have to be changed pretty quickly, wouldn't they?

NV: Absolutely. But B.C. and Alberta are phasing it in over a three-year period. To lessen the impact on some groups of people, Manitoba could look at a similar strategy. But the benefits would be overwhelming. The benefits to most Manitobans in terms of being able to ship goods and services to B.C. alone, particularly because it has large, deep-sea ports able to ship to other places around the world, are substantial. And free movement of labour and investment is something that is absolutely critical to prosperity.

FC: By virtue of its equalization boodle, Manitoba is able to offer basic public services like health and education at a much more expensive per capita rate than the provinces whose people are funding the transfers. Do you think the writing is on the wall? Do you think that should be made part of the calculation of federal equalization transfers?

NV: No I don't. Certainly you are right about the numbers, and one of things we have looked at and recommended is that the equalization be adjusted for the cost of providing goods and services. We know that the cost of providing goods and services, purely by nature of things like property taxes and wage rates, is a lot lower in Manitoba than it is in Vancouver or Calgary. So we need adjust equalization to account for some of those cost of living differences.

FC: Manitoba Hydro offers electricity for sale domestically at three-quarters of the cost of production, and if it charged market rates would take in at least a billion dollars more a year. Do

you think that should be made part of the calculation of federal equalization transfers?

NV: When you talk about equalization and transfers, it has to do with the government role in providing services.

FC: But resource revenues are included in the calculations for other provinces. Hydro-electricity provides a resource revenue. Why is that excluded?

NV: We would recommend that they do include a ten-province average including resource revenues and certainly you would want to look at any subsidies that Manitoba Hydro is giving to Manitobans. But the critical thing here is that the cost adjustment has to be for the fact that it is cheaper in this province to provide health care, education and social services because of the wage rates and because of other things like property values.

FC: One part of the “green wave” sweeping the country is a perceived need to build a national east-to-west power grid. Do you agree that it’s needed?

NV: I can’t really comment on the electricity grid because I am not an energy economist. But certainly on some of the green initiatives, one of the things that have to be done is that these initiatives have to be costed. People have to start to realize what these green initiatives are going to cost average families. I think that if people knew what these green initiatives cost, a lot less people would be signing onto them.

FC: Many of us who are unconvinced by theories of manmade global warming were disappointed when the Harper government flip-flopped on the issue. Do you think the Tories should have stuck by their guns?

NV: Well, we’re certainly seeing a movement towards – dare I say? – a religious type of atmosphere when it comes to the debate about global warming. I think the jury is still out. I think that we have to let science do the work here, instead of producing politically created documents like the IPCC report that was just released.

FC: How much danger are the Canadian people facing from the “watermelon” phenomenon?

NV: If you look at the environmental indicators released by governments, they show us that since the

1970s we have been improving. So the reality, in terms of the environment, is much different than what people perceive here in Canada.

FC: Do you think we should have legislated limits to the size of government?

NV: I am a firm believer in what is called a “tax expenditure limitation,” which basically takes power out of the government’s hand and puts it back into peoples’ hands. You limit the size of government spending or the growth in the size of government spending to inflation plus population growth, so that real spending doesn’t change. If governments want to spend beyond that, they have to go back to the electorate and get people’s authority to increase spending at a faster rate. If there are surpluses, those surpluses automatically go back to taxpayers. Many U.S. states have these tax and expenditure limitation laws and it would certainly be something for Canadian provinces to look at.