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Provincial Economic Freedom in Canada 1981-1998

by Faisal Arman,
Dexter Samida,
and Michael Walker

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Executive Summary

Economic freedom is vital to the well-being of all Canadians. Those provinces that liberate their economies receive dividends for their efforts in the form of higher rates of growth and higher levels of income per capita. When provincial governments restrict economic freedom, growth is dampened and income per capita declines relative to economically free jurisdictions.

In its simplest form, economic freedom involves the freedom to make choices, freedom of exchange, and protection of private property. Any major impediment to the exercise of these rights as a result of intervention by government is a violation of economic freedom. The freest of economies will operate with a minimal amount of government interference, relying upon personal choice and markets to answer basic economic questions such as what is to be produced, how much is to be produced, and for whom production is intended.

Provincial Economic Freedom in Canada tracks provincial economic freedom from 1981 to the present. It is a reliable indicator of economic freedom across the Canadian provinces and, since it is based on objective components, can be updated regularly in order to track future changes in economic freedom. There are 11 components grouped into four major areas: I. Government Operations and Regulations; II. Takings and Discriminatory Taxation; III. Interprovincial Trade; IV. Labour Market Regulations. After the data for each of these components were assembled, each province received a grade from zero through 10 for each component based on an objective rating scale.

Each component's grade was then weighted based on a system derived from the system used in the first two editions of *Economic Freedom of the World* (Gwartney, Lawson, and Block 1996; Gwartney and Lawson 1997). The weights used in *Economic Freedom of the World* were based on a survey of the participants in the Fraser Institute–Liberty Fund Symposia Series (see page 14; Gwartney and Lawson 1997: 7). The weights for components taken directly from the *Economic Freedom of the World* were modified for use with the Canadian provinces, which are subject to political and economic conditions different from those at work in international states. Weights for components created specifically for *Provincial Economic Freedom in Canada, 1981–1998* were calculated based on their assumed contribution to provincial economic freedom as compared to other items already included. These weights were then adjusted until they equalled one hundred. (See exhibit 1).

Economic Freedom and Economic Growth

This study also investigates the relationships between economic freedom and other economic variables. Economic theory suggests that some minimal level of economic freedom is necessary to spark economic growth and bring a nation or province an increased standard of living. Many economists and public-policy analysts disagree, however, about whether restrictions upon economic freedom beyond this level systematically reduce or increase economic welfare This is fundamentally a question about the size and role of government.

Statistical analysis done for this study clearly demonstrates that economic freedom as measured by the index of provincial economic freedom is positively related to provincial per-capita gross domestic product (GDP). Provinces that have pursued restrictive policies have suffered economically, while those that have fostered increased economic freedom have benefited. Moving up a single point in the index of provincial economic freedom adds an additional $2,433 to provincial per-capita GDP. When comparisons are made between relative freedom and relative economic well-being, the relationship is even more striking. This occurs because investment and labour tends to flow to areas with the best opportunities.

This study also shows that greater provincial economic freedom spurs increased economic growth. Due to random shocks affecting the entire Canadian economy, this relationship tends to fluctuate from year to year. In order to minimize the effect of these shocks upon our results, the relationship between relative changes in economic freedom and relative changes in provincial per-capita GDP was also investigated. This relationship was also statistically significant and a large portion of the relative variation in per-capita GDP is explained simply by the relative variation in economic freedom.

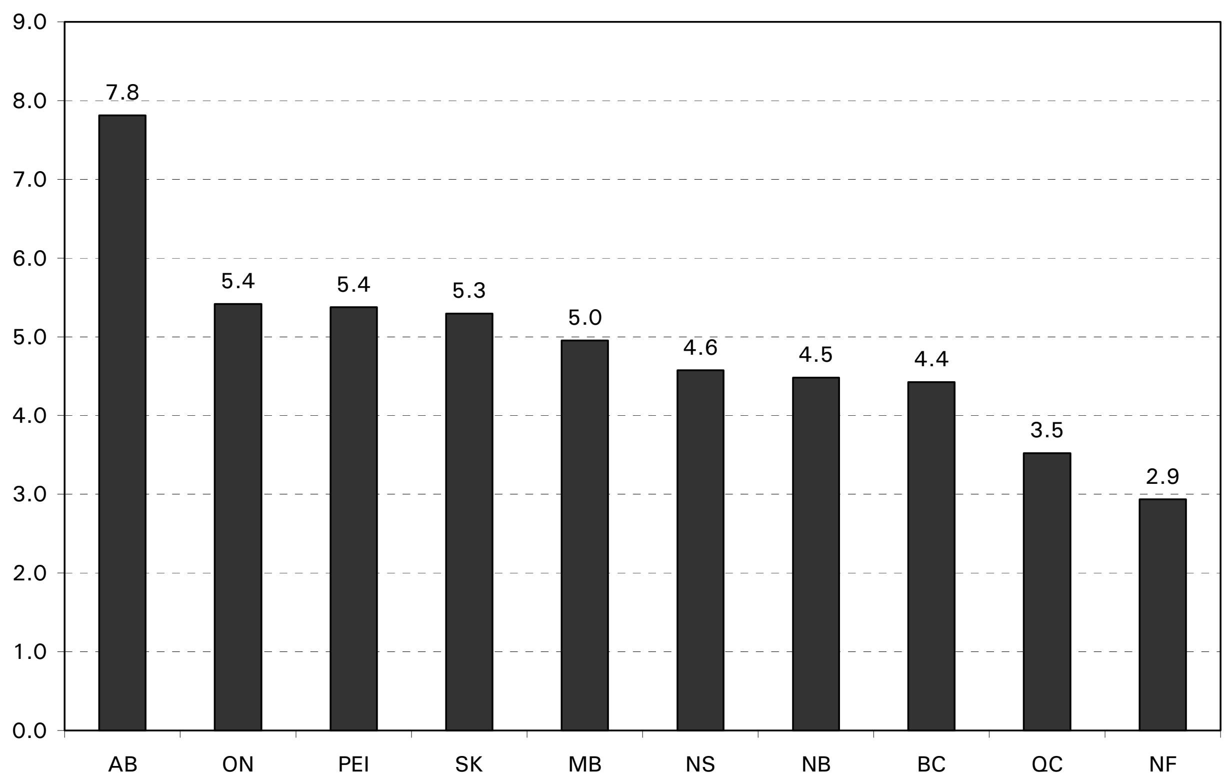
Most provinces had declines in economic freedom in the early 1980s due to an expansion of government; an increase in economic freedom appeared around 1989 as governments generally tried to reduce consumption and lower personal tax rates. The least economically free provinces tended to have modest increases in economic freedom throughout the measurement period but in all cases these provinces remained below the average level of economic freedom. This is unfortunate as the least free provinces are also Canada's poorest provinces. Restraining market activity in these provinces imposes costs on those who can least afford them. The statistical models developed in this study suggest that the cost to jurisdictions that are less economically free than Alberta is in the range of $6,000 to almost $13,000 per person per year.

Economic Freedom: Provincial Ratings

The provinces of Alberta and Ontario have the greatest economic freedom in Canada. Alberta and Ontario have maintained first and second place respectively throughout the period of measurement, except in 1985 and 1989 when Ontario took first place. Since 1993, Alberta has ranked first or second in each of the four major areas of the index and has had particular success in reducing personal and corporate tax rates. Since 1993, Ontario has been struggling to maintain a distant second position, with Prince Edward Island positioned to overtake it. Ontario's best ranking is in the Government Operations area of the index, due to the government's reduction of its consumption relative to that in other provinces.

At the other end of spectrum, Newfoundland has been the least economically free province in Canada throughout the period under study. New Brunswick and Quebec also consistently achieved low ratings from 1986 to 1996. In recent years, Newfoundland has placed in either second last or last place in each of the four major areas of the index. Areas of particularly poor performance include

Figure A: 1998 Estimate of Provincial Economic Freedom



Note: Due to rounding, the scores for Ontario and for Prince Edward Island appear to be equal; in fact, Ontario's score is slightly better than that of Prince Edward Island.

government consumption, and transfers and subsidies. Quebec's low ranking is due to a large number of transfers and subsidies and considerable business regulation. New Brunswick's low overall ranking was due to a very poor showing in the Government Operations and Interprovincial Trade areas of the index.

Changes in Economic Freedom in the Provinces

Prince Edward Island has shown the greatest improvement in the freedom rankings. In 1981, Prince Edward Island was the sixth freest province in Canada. From 1989 through to 1996, Prince Edward Island made modest gains in economic freedom by reducing government consumption as a percentage of GDP, and the annual minimum wage as a percentage of per-capita GDP, moving from a rating of 4.8 in 1989 to 5.4 in the 1998 estimate. The result of these changes was an improvement to third place.

British Columbia showed the greatest drop in economic freedom. From 1981 to 1994, it was able to maintain its standing among the five most economically free provinces; from 1985 to 1993, it was ranked the third freest province. However, as a result of changes in its policies after 1994, including an increase in government consumption as a percentage of GDP, a rise in the annual minimum wage as a percentage of per-capita GDP, and an increase in personal and corporate taxes, British Columbia tumbled to sixth place in 1995 and to eighth position in the 1998 estimate.

Manitoba showed a modest loss of economic freedom, dropping from 5.5 in 1981 to 5.0 in the 1998 estimate. This was due to a drop in its ratings for categories (I) Government Operations and Regulations and (II) Takings and Discriminatory Taxation. Nevertheless, Manitoba maintained its ranking as the fifth freest jurisdiction.

Saskatchewan's economic freedom has fluctuated greatly, losing ground from 1981 to 1993 and then gaining ground relative to other provinces from 1994 to 1996. These fluctuations were caused by a lack of fiscal restraint until recent years and the retention of a large government-enterprise sector. In the 1998 estimate, Saskatchewan was the fourth most economically free province.

Nova Scotia ranked eighth freest province in 1981 and seventh freest province in 1985. It was the fourth freest province in 1989 and fluctuated between sixth and seventh freest for the rest of the measurement period. The increase in ratings in 1989 was due to reduced government consumption, a lower top marginal tax rate, and a reduced minimum wage, while the subsequent decline was the result of lower scores in (I) Government Operations and Regulations and (II) Takings and Discriminatory Taxation of this index.

For a complete listing of the ratings of each province, please see pages 38 to 40.

Introduction

> *Most people prefer to choose for themselves. This indicates that freedom, including economic freedom, has intrinsic value. Adam Smith noted that human beings have a natural inclination to "truck and barter." Restrictions on the freedom to choose and engage in voluntary exchange deny human beings something they value–something that is an integral part of their humanity. In addition, economic theory indicates that economic freedom affects incentives, productive effort, and the effectiveness of resource use*
>
> –Gwartney, Lawson, and Block 1996

Modern governments are under increasing pressure to change, to remedy years of inefficient bureaucracy, and to open their borders and markets. Although these demands often come in the form of requests for lower taxes or a less onerous regulatory burden, the common thread underlying these requests is a need for more economic freedom. Those governments that respond positively to this appeal enable their citizens to grow prosperous in the age of the global economy while those who do not will relegate those under their jurisdiction to a decreasing relative standard of living.

Traditional Keynesian economic analysis has suggested a large and varied role for government in the economy. For many years, this has been the dominant view among economists and policy makers. Fortunately, it appears that this tide is reversing. As our understanding of economics advances, it becomes clearer that the market is more than just an anonymous process by which rewards and punishments are distributed. Those who criticize the market and favour government intervention seem implicitly to argue that these impersonal forces are a zero sum game–one person must lose for another to gain. What these commentators ignore is the role that the market plays in increasing the welfare of *all* participants, not only those in the upper echelons. When participants are allowed to trade something of personal value for something of greater personal value, they increase their welfare. This is true whether the trade is apples for oranges or labour for wages.

"[F]reedom to choose, supply resources, compete in business, and trade with others is a central ingredient–perhaps the fundamental element–of economic progress" (Gwartney, Lawson, and Block 1996). History has provided ample evidence that economic freedom sparks and maintains economic growth but opinion remains divided as to whether government intervention, once society rises past some level of economic well-being, is helpful or destructive to further economic progress. In the past, evaluating the relationship between economic freedom and economic growth was nearly impossible due to the lack of an objective definition of economic freedom and a means by which to measure it (*The Economist* 1996). Recent empirical research published jointly by The Fraser Institute and 53 research institutes in 53 countries in *Economic Freedom of the World 1975-1995*, *Economic Freedom of the World 1997: Annual Report* and *Economic Freedom of the World: 1998/1999 Interim Report* has gone a long way in filling those gaps. This annual examination of economic freedom provides detailed definitions of the components of economic freedom and a quantified analysis of economic freedom in 115 countries over a 25-year period. The research provides strong evidence that countries with greater economic freedom achieved not only greater economic growth but also higher per-capita gross domestic product (GDP). Per-capita GDP is a useful indicator of the relative income level of individuals within an economy. The validity of the study is supported by data across a wide enough range of countries and over a long enough period of time to test the credibility of the link between freedom and prosperity. It is clear that economic freedom is the way in which a country grows and its citizens become affluent.

As a point of note, for 1990 to 1997 Canada was ranked the sixth freest economy in the world. Countries with consistently higher levels of economic freedom than our own have delivered greater economic benefits to their citizens and, by restricting economic freedom, we have done more than limit individuals' choices; we have also removed a piece of their livelihood through a reduction in economic growth. While Canada remains at virtually the same level of economic freedom, other countries are taking the lead in increasing economic freedom.

Object of the Index

Provincial Economic Freedom in Canada, 1981–1998 was modeled on the research done for the various issues of *Economic Freedom of the World*. Several components of this world-wide index were re-engineered to measure levels of economic freedom among the Canadian provinces. The object of *Provincial Economic Freedom in Canada* is twofold. First, it defines economic freedom and illuminates the intricate pattern of restrictions that provincial governments can impose upon economic freedom. Second, it shows the extent to which these intrusions exist in each of the provinces as well as the direction these restrictions in freedom take over time. By using empirical data provided by Statistics Canada and other statistics-gathering organizations over a period of sufficient length, we show clearly the importance that individual provinces have placed on either enhancing or inhibiting economic freedom.

Impositions upon economic freedom are not blatantly obvious in the developed economies of the world. Constraints on economic freedom in the Canadian provinces exist in a wide range of policies and regulations embedded in the dictates of government. The effects of such violations are less evident in Canada than elsewhere due to the huge endowment of resources in our country and a corresponding capacity to bear all kinds of economic inefficiencies without their adverse impact being felt (Easton and Walker 1992). Economic restrictions should not, therefore, be of less interest to the population as these endowments are only valuable inasmuch as they provide for the well-being of society. When government squanders our resources with red tape, present society and future generations suffer economic losses. This study breaks ground in cataloging these restrictions and providing a ranking for each of the Canadian provinces. The results and statistical analyses provide ample proof that economic freedom is something that we should maintain and increase.

Definition of Economic Freedom

In its simplest form, economic freedom involves the freedom to make choices, freedom of exchange, and protection of private property. "When economic freedom is present, individuals are free to make economic choices such as how to use their time and other resources, what goods to consume, and what business and investment alternatives to pursue" (Gwartney and Lawson 1997: 2; see also Gwartney, Lawson, and Block 1996). Any impediment to the exercise of these rights as a consequence of intervention by government is a violation of economic freedom. The freest of economies will operate with a minimal amount of government interference, relying upon personal choice and markets to answer basic economic questions such as what is to be produced, how much is to be produced, and for whom production is intended. Governments in such economies show a healthy respect for the competitive markets and their outcomes.

In an economically free society, the government has two main functions. The first is the protective function.

> A government's protective function seeks to prevent individuals from physically harming the person or property of another and to maintain an infrastructure of rules within which people can interact peacefully. The crucial ingredients of this infrastructure include the enforcement of contracts and the avoidance of restrictions, regulations and differential or excessive taxes that would restrain exchange (Gwartney, Lawson, and Block 1996: 22).

The second function of government

> involves the provision of public goods–goods that have two distinguishing characteristics: (1) supplying them to one individual simultaneously makes them available to others, and (2) it is difficult, if not impossible, to restrict their consumption to paying customers only (Gwartney, Lawson, and Block 1996: 22).

Consumer choice and economic freedom is restricted when governments move beyond the supply of public goods and the protection of persons and property into the provision of private goods. Governments in Canada, like those in most modern states, have unprecedented control of private production, the operation of enterprises, and the protection of government firms from the discipline of competition. They also impose price controls and initiate numerous other expenditures and regulatory activities having little to do with the protection of property rights or the provision of public goods.

Given the sheer number of government operations and regulations, precise measurement of all governmental activities is an impossible task. *Provincial Economic Freedom*

Exhibit 1: Areas and Components of the Index of Provincial Economic Freedom and the Weights Assigned to Each

	weight
I Government Operations and Regulations (freedom to decide what is produced and consumed)	
(a) General consumption expenditures by government as a percentage of GDP	7.8
(b) Size of government-operated enterprises and debt guarantees as a percentage of GDP	6.9
(c) Price controls	7.5
(d) Regulatory effort (expenditures on regulation by government as a percentage of business revenue)	9.0
II Takings and Discriminatory Taxation (freedom to keep what you earn)	
(a) Transfers and subsidies as a percentage of GDP	11.9
(b) Top marginal tax rate and the income threshold at which it applies	13.7
(c) Direct corporate taxes as a percentage of corporate profits	11.2
(d) Provincial sales tax	11.0
III Interprovincial Trade (freedom of trade between provinces)	
(a) Occupational Licensing	7.1
(b) Marketing Boards	7.9
IV Regulation of the Labour Market (freedom of contract between labour and management)	
(a) Minimum Wage Legislation	6.0

in Canada evaluates 11 components (see exhibit 1) and provides insight into the relationship between government activity and economic freedom in several important areas. While at this stage of development the components are not exhaustive, they do provide a credible indication of the degree to which government policies have had an impact on provincial economic freedom.

Components of the Index

The eleven components of the index of provincial economic freedom are divided among four major areas: I. Government Operations and Regulations; II. Takings and Discriminatory Taxation; III. Interprovincial Trade; and IV. Labour Market Regulations. A scale from zero to 10 was used to rate each component in the index. Ten is the highest possible score and indicates relatively high economic freedom while a score of zero is the lowest a jurisdiction can receive. Many of the components and definitions are adapted from the three editions of *Economic Freedom of the World* (Gwartney, Lawson, and Block 1996; Gwartney and Lawson 1997; Gwartney and Lawson 1998).

I. Government Operations and Regulations

I(a). General Consumption Expenditures by Government as a Percentage of GDP

Government operations and regulations in the economy have an impact on consumer choice and economic freedom. The two broad functions of government consistent with economic freedom are limited to its protective capacities and its role in providing public goods. Most modern governments have ventured far beyond these functions and involve themselves in the direction of private production, the operation of businesses, the protection of government firms from the discipline of competition (both through the creation of monopolies and by subsidizing losses of government firms), the imposition of price controls, the redistribution of income and wealth, and numerous other discriminatory expenditures and regulatory activities. All these activities are contrary to economic freedom and are a burden to society.

Provincial governments have the authority to take a portion of an individual's income (through taxation) and either to transfer it to others or to use it to operate enterprises or agencies. Further, provincial governments have the power to set prices, limit entry into markets and occupations (through the establishment of marketing boards and regulation of professions and industries), mandate the provision of services by private parties (usually businesses), and impose any number of other regulations on individuals or businesses.

When consumption expenditures by government increase as a share of GDP, political expedience is substituted for market decisions and coordination. All things being equal, more public spending means less spending by individuals and households. "As government expenditures increase, more and more of these expenditures tend to be channelled toward activities outside of the protective and productive functions of government" (Gwartney, Lawson, and Block 1996: 23). As government begins to take over more portions of the economy, there is almost always a loss of efficiency. Research in progress at The Fraser Institute suggests that once government revenue is above approximately 30 percent of GDP there are substantial economic costs to the economy. Canadian governments have been above this level for decades. The complicated coordination of prices and output that the market handles free of charge requires an expensive bureaucracy to operate when it is under the auspices of a government organization.

For the last two decades, expenditures by provincial and local governments have been rising faster than the nominal GDP. Within total expenditures, there have been trends in the relative importance of the type of expenditure. Government expenditures fall under two broad categories: *exhaustive* and *distributive*. Exhaustive spending encompasses expenditures such as consumption spending and capital formation—*e.g.*, varied services such as education, health care, and police protection. Distributive spending encompasses such expenditures as interest on the public debt and transfers to businesses and persons. In real terms, expenditure on goods and services, both consumption and capital, has grown slower than GDP over the past two decades. Government operations such as transfers to persons and businesses, and interest on the public debt have been growing much faster in real terms than GDP. This suggests that governments have been increasingly willing to abandon their traditional role and pursue other objectives. This shift has had negative consequences for economic freedom and economic well-being.

For most measurement years, the index uses total provincial government expenditures as a percentage of GDP from the Provincial Economic Accounts. The 1996 measure of this component uses the 1996 Financial Management System (FMS) data provided by Statistics Canada. Total provincial government expenditures (as measured by FMS accounts) as a percentage of GDP was used. This was used because the 1996 Provincial Economic Accounts data was not available when the index was being compiled.

Data Source: System of National Accounts, Provincial Economic Accounts, Annual Estimates disk version (1961–1996), Statistics Canada, Catalogue No. 13–213.

I(b). Size of Government-Operated Enterprises and Debt Guarantees as a Percentage of GDP

A government-operated business enterprise represents the substitution of political coercion for market decision-making. Government enterprises are fundamentally different from private businesses. Their start-up capital is coercively appropriated from taxpayers whereas private firms obtain funds voluntarily from investors willing to risk their own wealth. An intelligent investor will not lend money without assurance that it will be recovered. Yet this is what the government does with taxpayers' money whenever it funds another dubious government enterprise. Investors typically calculate the returns of an investment relative to the investment's risk before investing. Bearing risk is one of the beneficial functions that these individuals perform. Without someone willing to accept these risks, society would have trouble advancing. Politicians calculate returns to investment in terms of votes, indifferent to the effect on the economy. Subsequent investment decisions of public-sector firms are made by political officials playing with the taxpayers' resources. Entrepreneurs who are capable of attracting financial capital know that they must return something of value to investors to be successful. The return politicians primarily worry about is their return to power. Needless to say, both groups have vastly different incentives. Subsidies, favourable tax treatment, and regulations are often used to protect state-operated firms from private competitors. If a government project fails to generate enough revenue to cover its costs, there is no bankruptcy mechanism to bring it to a halt. Public-sector enterprise stifles market forces by substituting politically pragmatic decisions for decisions based solely upon the financial situation of a firm. Government bureaucrats seldom lose their jobs for bad decisions whereas their private counterparts have levels of accountability unmatched in the public sector. Similar perverse incentives exist when debt guarantees are issued by the government. When protected by debt-guarantees, firms are able to engage in riskier or less profitable projects–at someone else's expense–than they might otherwise have. This creates distortion in the economy and results in a further erosion of decision-making based on competitive forces. By issuing these guarantees, the government becomes an influential partner in these firms.

To estimate the importance of government business decision-making within a province, we measure the value of total liabilities and net worth of government business enterprises and the value of government debt guarantees as a percentage of provincial GDP. This illustrates the relative size of such enterprises within provincial economies and allows for cross-provincial comparisons.

Data Source: Public Sector Assets and Liabilities, Historical Overview, Financial Management System, Statistics Canada, Catalogue No. 68–508. In the case of Quebec, the dollar value of the Quebec Pension Plan has been deducted, because for the other provinces this service is provided federally. Years 1993 and 1994 were obtained using the disk version of this dataset.

I(c). Price Controls

Price controls interfere with the freedom of buyers and sellers to undertake exchanges even when both parties agree on the terms of trade. Price controls are a forced transfer of property from a private owner to another individual. For example, if price controls on rental housing cut the rate of return of a property in half, half the property is seized from the owner since, presumably, landowners are in business to earn a living and not to subsidize tenants in high-rent cities. Surprisingly, in many cases this is a transfer from the poor to the middle class, as many rental operators are less wealthy then their tenants (Lehrer 1991). Since price controls constrain exchange and expropriate property from owners, they are inconsistent with economic freedom. The more price controls are used to distort prices, the larger are the associated inefficiencies.

This component measures the extent of price controls imposed by government on goods and services for each province.

Data Source: Research undertaken by Faisal Arman from provincial government regulations.

I(d). Regulatory Effort

One of the most important though often overlooked challenges to Canada's economic competitiveness has been the regulatory burdens imposed by all levels of government on businesses, large or small (Mihlar 1996). The ability of business to operate with increased efficiency and productivity (the essential requirement of a higher standard of living) is restricted by the ever expanding regulatory burdens imposed by well-meaning governments. Such burdens are costly and chaotic for business because they are inherently unpredictable. Politicians themselves rarely know which regulation or law will be in vogue in months to come. In the course of a year, the typical parliament enacts all sorts of statutes covering all types of activities. Often these deleterious activities receive little media coverage or public debate.

The number of regulations affecting people and businesses in Canada has escalated in the last two decades, and there has been an accompanying increase in the costs of compliance associated with such regulations. Regulatory burdens, like high taxation, are an impediment to additional investment and new jobs. This index measures the resources expended by provincial governments in implementing and maintaining regulations on businesses as a percentage of business revenue.

Data Source: Business revenue data was compiled from the Provincial Economic Accounts, Statistics Canada, Catalogue No. 13–213 (subtracting total government consumption from GDP). Government expenditure on regulation data was prepared on a public-accounts basis by Dr. Paul Reed, Senior Social Scientist, Statistics Canada, 1996.

II. Takings and Discriminatory Taxation

Modern governments are particularly likely to engage in activities that confiscate from one group and give to another. This is true for both the budgetary and regulatory policies of government. The justification often seems incomprehensible as there are no logical reasons why the government should pick the pockets of its citizens on behalf of farmers, fishers, or other receivers of subsidies. When governments play favourites and take from one group to transfer to another, or impose the costs of public services disproportionately on particular groups, they violate economic freedom. Our research has identified four domains where discriminatory behaviour in the political sphere is particularly important. These areas are (a) Transfers and subsidies as a percentage of GDP; (b) Top marginal tax rate and the income threshold at which it applies; (c) Direct corporate taxes as a percentage of corporate profits; and (d) Provincial sales tax.

II(a). Transfers and Subsidies as a Percentage of GDP

Transfers and subsidies violate the freedom of individuals to keep the value of their labour or investments. When governments tax one person in order to give money to another, they separate individuals from the fruits of their labour and reduce the real returns of such activity, lowering the incentive to be productive. This is true whether funds are transferred from the rich to the poor or, as is often the case, from the poor to the rich, from one racial group to another, or from the politically disorganized to the politically powerful. The taking of property, including labour services, without fully compensating the rightful owner is an infringement of economic freedom. The ratio of transfers and subsidies to GDP indicates the degree to which various provinces use their budgets to engage in taking and transfer activities. Low ratings are given to those provinces with the greatest portion of their GDP dedicated to transfers and subsidies.

The 1996 measure of this component uses 1995 Provincial Economic Accounts data. Data from 1996 was not available during the completion of the index.

Data Source: System of National Accounts, Provincial Economic Accounts, Annual Estimates disk version (1961–1996), Statistics Canada, Catalogue No. 13–213.

II(b). Top Marginal Tax Rate and the Income Threshold at Which It Applies

High marginal tax rates discriminate against productive citizens and deny them the benefits of their efforts. In essence, such tax rates seize wealth from certain taxpayers without providing them an equivalent increase in service.

Generally, high marginal tax rates are a very inefficient form of raising government revenue, since people will often reduce their work effort and make other adjustments when a large proportion of their marginal earnings are taxed away–the existence of tax havens and other loopholes is well known. Also, when marginal taxes reach a certain level, the returns for dishonesty become very high. Under certain circumstances, a normally honest citizen will be induced to cheat by a revenue-hungry government. Thus, high marginal tax rates impose an additional cost – and loss of freedom–over and above the revenues transferred to the government. Taxes are, in effect, a negative subsidy applied to productive activity.

This component is based on the ratings used in the *Economic Freedom of the World*. It takes into account both the highest marginal tax rate as well as the income threshold at which it applies.

Data Source: "Finances of the Nation," Canadian Tax Foundation 1982, 1985, 1989, 1993, 1994, 1995, 1996, 1997 (entitled "The National Finances" before 1995).

II(c). Direct Corporate Taxes as a Percentage of Corporate Profits

Within an economy, technical progress drives growth and is embodied in investment in new capital. High corporate taxes deter new investment while simultaneously reducing future economic well-being and the associated benefits of a higher standard of living. By forgoing the latest and most efficient technology, labour productivity is constrained. Labour productivity is the key to a higher standard of living since all production ultimately becomes consumption. The more efficient production is, the more products that the consumer can afford as wages are representative of labour productivity. The more a nation can produce, the more each citizen can receive. Weakening production therefore reduces a society's standard of living. High corporate tax rates impose costs over and above the revenues transferred to the government and result in lower levels of investment, less employment, and a slower growth rate. Though some activists claim that corporate taxes are simply paid by the rich, this is not the case. Taxes that reduce efficiency and limit production hurt everyone, irrespective of income bracket.

This component was calculated using the direct taxes paid by corporations as a percentage of corporate profits within each jurisdiction. Although, due to differences in tax code, it would be preferable to have a marginal measure, there is no accurate marginal measure for cross-provincial comparisons.

Data Source: "Provincial Economic Accounts," 13-213. Statistics Canada.

II(d). Provincial Sales Tax

Sales taxes on goods and services limit individual discretion in consumption choice as a result of the increased costs that they impose. Sales taxes create a gap between the cost of the good or service and the price that one must pay to obtain it. In a normal transaction, the person buying an item places more value on the item than the seller (or he would have no reason to purchase this item). Every transaction adds to the welfare of society by transferring this sliver of value (the difference between the value to the consumer and the price he pays) to the consumer. Taxes interrupt this beneficial exchange when the tax increases the cost of the item above the value of the object to the consumer. For example, if a consumer values a certain brand of molasses at three dollars a litre, and the sale price is two dollars, the consumer receives a net benefit of one dollar for every litre he purchases. This gain comes at the expense of no one and is a true gain for society. If taxes raise the price by 50 cents, then 50 cents of the previous gain is transferred to the government. When taxes raise the price of molasses past three dollars, the consumer will stop purchasing molasses (or rely on the black market for molasses) as its price is greater than the value the he places on it. Each purchase of a litre of molasses was a one dollar net benefit for society in the first two examples. In the first instance, the benefit was captured entirely by the consumer, and in the second, the government and the consumer split the benefit evenly. When the consumer halts his purchase of molasses, this represents a loss to society that is not captured by another part of society. Thus while sales taxes (or any other tax) raise revenue, there is, in the words of economists, a deadweight loss to society above the cost of the tax to the consumer. This loss is difficult to measure but there is no doubt that this loss exists and that it grows as the level of provincial sales tax rises.

This component measures the level of sales tax within each province. Values for 1994 were taken from the Manitoba Provincial Budget (1994). GST is not included in these calculations as it is a federally levied tax.

Data Source: "Finances of the Nation," Canadian Tax Foundation 1982, 1985, 1989, 1991, 1995, 1996, 1997 (entitled "The National Finances" before 1995).

III. Interprovincial Trade

Economists of all persuasions have recognized the efficiency gains made possible by free trade. If there were free trade among the Canadian provinces, residents of different provinces would gain from interprovincial divisions of labour, economies of scale, and specialization in areas where they have a comparative advantage.

Trade allows trading partners to produce a larger joint output than that which would have been produced separately. From this larger production each partner can benefit. An easy way to see how trade is beneficial is to examine the manufacture of automobiles. We can either purchase automobiles from domestic firms or we can import them. Importing automobiles requires an outflow of Canadian dollars. Our dollar has little intrinsic value embodied within it; it is not priceless art or precious metal. Those who accept Canadian dollars wish to exchange these slips of paper for something they want. If we imagine that the foreign exporters of automobiles desire Canadian wheat, then the Canadian dollar becomes an intermediary in the trade of automobiles for wheat. If the government imposes a tariff on the import of foreign automobiles, this drives up their price and lowers demand. This, in turn, lowers demand for Canadian wheat. Barriers to trade do not protect the Canadian economy from competitors; barriers only protect the particular industry–in this case, domestic manufacturers of automobiles–at the expense of another industry–in our example, farmers. This is equivalent to a transfer from farmers to automobile manufacturers without compensation, and represents a violation of economic freedom (Friedman 1996).

Freedom of exchange is central to economic freedom; hence any circumstance that makes it difficult for buyers and sellers of goods, services, capital, or labour to complete a mutually beneficial transaction can be defined as a "barrier" to trade (Trebilcock and Schwanen 1995). The data in this area focus on two types of restrictions: labour mobility and barriers to trade in food and agricultural products. The components in this area do not by any means cover all the barriers to trade that the provinces have erected but provide an illustrative sample of factors that are quantifiable. As a proxy measure for a kind of barrier that is difficult to evaluate, we believe that this component reflects the impediments to trade among the provinces.

III(a). Occupational Licensing

Each province is empowered to regulate occupational standards, licensing, certification, registration, and residency requirements. They are not, of course, required to regulate, but this option is often overlooked. Since provinces seldom work in tandem in this regard, these bureaucratic rules create barriers to mobility of labour. Such measures prevent the free movement of labour in seeking opportunities in other provinces freely and without hindrance. Subject to certain qualifications, any worker qualified for an occupation in one jurisdiction in Canada should have access to employment opportunities in any other jurisdiction. These restrictions were not created in order to protect consumers in each province, as national standards could serve this purpose if necessary, but instead to protect the interests of entrenched labour in their respective provinces. The restriction of mobility of labour is clearly a violation of individual economic freedom and one must ask if it is really necessary for provinces to restrict the free movement of beekeepers or hairdressers. The extent to which labour mobility is hampered in each province is reflected in the number of occupations that each province regulates. The higher the number of regulated occupations, the more labour mobility is restricted.

Data Source: R.G. Evans and W.T. Stanbury, "Occupational Regulation in Canada," a background study prepared for the Economic Council of Canada, Regulation Reference, 1980. Updated through to 1995/96 by Faisal Arman using provincial statute records.

III(b). Marketing Boards (Agricultural)

Marketing boards represent a significant regulatory instrument. The majority of new provincial marketing boards have been those with supply management powers that enable them to control the supply of products by setting prices and production quotas and by disposing of "surplus" output. Import controls are becoming a standard appendage of supply management (Evans and Stanbury 1980). In essence, marketing boards are cartels that regulate the supply, price, and flow of goods. This component measures the share of farm receipts influenced by supply management boards by province as a ratio of total farm receipts (Canadian Wheat Board payments are excluded from total farm receipts where necessary). The greater the share of farm receipts collected through supply management boards, the lower the score given in this component. These policies encourage less efficient land use and extract money from consumers to be passed to producers. Instead of sparking efficiency gains, our system of marketing boards has allowed less efficient producers to exist. This wastes precious resources and has undoubtedly lowered the standard of living of Canadians.

Data Source: Farm Cash Receipts and Payments Summary Report, Agricultural Division, Statistics Canada 1981, 1985, 1989, 1993, 1994, 1995, 1996, Catalogue No. 21–603 UPE.

IV: Regulation of the Labour Market

IV(a). Minimum Wage Legislation

High minimum wages increase unemployment. Minimum-wage legislation is often enacted in hopes of benefiting those with low incomes but, in fact, it has the perverse result of reducing demand for low-skilled workers and boosting demand for their more highly skilled counterparts. Thus, the costs of such policies are borne by those whom they were enacted to help. Empirical evidence from both developed and developing countries confirms the accuracy of these statements and serves as an important reminder to jurisdictions seeking to influence the market through legislation (Robinson 1997). *The Economist* magazine, when discussing the proposed national minimum-wage policy in Britain, said that the proposal "would fly in the face of economic logic" and that "most low-paid workers are not, in fact, poverty-stricken, but rather second-earners in middle-income households. Thus, the minimum wage is not a well-targeted instrument for helping the poor." Minimum wages drive up the cost of doing business which reduces jobs, hurting poor families further. The "reason why a minimum wage would not help the poorest homes is that many of them have no one in work. Worse, a minimum wage would destroy jobs—the more jobs the higher it is set—by stopping people willing to work at low wages from doing so" (*The Economist* 1997: 54–55).

This component measures the annual income earned by working at the minimum wage as a ratio of per-capita GDP. This is a measure of a province's ability to bear a higher wage since per-capita GDP is representative of the average productivity of the labour force. As the minimum wage grows to be a higher percentage of provincial per-capita GDP, there are increasingly negative economic consequences.

Data Source: Human Resources Development Canada, Statistics Canada and the Provincial Economic Accounts, Statistics Canada, 1961–1996 (disk version), Catalogue No. 13–213.

Methodology

Estimates for 1998

The estimates for 1998 used in *Provincial Economic Freedom in Canada* were based upon the 1996 data for each of the 11 components of the index. This year was chosen because there were data available for this year for most of the 11 components. Updates will be made to the index when newer data becomes available.

Weighting the Components

Each component of the index developed for *Provincial Economic Freedom in Canada* has a different influence on the economic freedom within a province. Some restrictions are inherently more detrimental to economic freedom than others. In light of this, a weighting scheme is needed to arrive at a final measure of provincial economic freedom.

After the data for each of the components were assembled, each province received a grade from zero through 10 for each component. Each component's grade was then weighted based on a system derived from the system used in the first two editions of *Economic Freedom of the World* (Gwartney, Lawson, and Block 1996; Gwartney and Lawson 1997). The weights used in *Economic Freedom of the World* were

> based on a survey of the participants in the Fraser–Liberty Fund Symposia Series … We constructed a survey instrument which described the 17 components in our index and asked the participants of these conferences to provide us with their views concerning the weights that should be attached to each of the components. Since all of these people attended at least one of the conferences, we were reasonably sure of their familiarity with the concept of economic freedom and the factors that influence it. The average weight suggested by the respondents was then used to weight the components and derive the summary index for each of the years. (Gwartney and Lawson 1997: 7)

The weights for components taken directly from the *Economic Freedom of the World* were modified for use with the Canadian provinces, which are subject to political and economic conditions different from those at work in international states. Weights for components created specifically for Provincial Economic Freedom in Canada were calculated based on their assumed contribution to provincial economic freedom as compared to other items already included. These weights were then adjusted to total 100. (See Exhibit 1).