
**AN UPDATE TO TD ECONOMICS' 2002
REPORT ON THE GREATER TORONTO
AREA (GTA) ECONOMY**

TD Economics

Special Report

July 17, 2007



AN UPDATE TO TD ECONOMICS' 2002 REPORT ON THE GREATER TORONTO AREA (GTA) ECONOMY

Executive Summary

Five years ago, TD Economics released a comprehensive report on the opportunities and challenges facing Canada's largest urban region: *The Greater Toronto Area Economy: Canada's Primary Economic Locomotive in Need of Repairs*. In light of the flurry of developments that have transpired in the region since 2002, an update to the study was warranted. This report represents a look back at the last half decade, with a particular emphasis on answering three questions: what went right, what went wrong and what still needs to be done?

Many economic surprises in 2002-06

The 2002 report contained a 5-year economic forecast with some lofty expectations for the GTA. With the U.S. economy poised to rebound strongly from its recession at the outset of the decade and Canadian interest rates plumbing the depths, there appeared to be little stopping the GTA economy from recording brisk real economic growth of 3-3.5% per year and job creation of 2% during the next five years (2002-06). Even more importantly, the region appeared set to reverse – at least temporarily – the downtrend in real income per capita relative to other large North American city regions that had been witnessed during the 1990s.

The actual economic path taken since 2002 has been rife with surprises. The U.S. economic revival would unfold as expected, but a number of other developments would soon emerge that had eluded forecasters' radar detection. In addition to disruptions such as SARS and the power blackout of 2003, the region has struggled to adjust to a massive appreciation of nearly 50% in the value of the Canadian dollar against the greenback, a tripling in the average price of commodities and a rapid acceleration in Chinese competition. Nowhere was the impact felt more than in the manufacturing sector, where about 100,000 jobs – or about one in five – has been shed in the GTA since mid-2002. This is in stark contrast to the half decade leading up to the 2002 study, when manufacturing *added* 100,000 jobs.

This about-face in manufacturers' fortunes has weighed on the region's growth, but fortunately, not derailed it. One key counterbalancing force has come from the housing market, where the boom extended into its second decade, spreading offsetting benefits throughout the economy. A sizeable share of the 150,000 combined employment advance in the 2002-06 period in financial services, retail and wholesale trade and professional services was almost certainly owing to housing-related demand for credit, home renovations and legal and other services.

Another unanticipated setback came in 2003, when the newly-elected McGuinty government unveiled a \$5.6 billion deficit. However, the Province has been able to eliminate the shortfall gradually without inflicting any collateral damage on the economy, assisted in part by rising transfer payments from the federal government.

Economic gains fall short

Putting it all together, real GDP growth ultimately came in at 2.5% per year in 2002-06 – short of our expectations, but a respectable showing under the circumstances. Meanwhile, the rate of average annual job creation actually came in bang on our forecast of 2%. And, in line with our projections, the region's population base continued to grow at a rapid pace of almost 2% per year in 2001-06, as the GTA continued to attract more than two in five of all Canada's newcomers.

The GTA's resilience in the face of the recent adversity has been encouraging. Still, the region continued to lose ground where it truly counts – in relative standard of living. With the moderate economic gains diminished by rising population in the GTA, real GDP per capita in the region increased at only 0.5% per year, about one-half the rate of the nation as a whole and one-third of the pace of other large city-regions in Canada. A comparison of real personal income per capita (another proxy of living standards) showed the GTA slipping further behind major U.S. cities – from US\$7,500 in 2002 to US\$8,500 in 2006.

Encouraging moves on the policy side

In the 2002 study, our view was that with the medium-term growth outlook relatively free of clouds, policymakers and leaders in the GTA could focus their attention on dismantling the longer-term roadblocks to growth and prosperity. We cited 6 areas in particular that required significant attention:

- Strengthen competitiveness
- Increase support for education
- Address growing urban sprawl
- Reduce poverty
- Reverse erosion of infrastructure
- Reduce shackles on municipalities

Although the surprising events since 2002 had the potential to significantly deflect attention toward taking measures to prop up short-term growth, government budgets have done a laudable job chipping away at these longer-term roadblocks. We discuss these initiatives on pages 10-23 of the Update. Notable mentions include substantial moves to reinvest in education and infrastructure, with the latter area further benefiting from last month's important \$17 billion funding announcement for GTA-wide transit. Some other highlights include new measures aimed at helping low income individuals, stimulating investment in the auto sector, new Municipal Acts, and a new Growth Plan for the Greater Golden Horseshoe.

Stepped up efforts required

At the same time, however, accelerated efforts will be required by the region's players to counter some of the economic headwinds and ensure that the GTA economy flourishes in the next decade and beyond.

An illustration of the one-step-forward two-steps-back is in the area of competitiveness. All levels of government have taken positive steps in recent budgets. Chief among them include moves by the federal and provincial governments to eliminate capital taxes, which are highly destructive to growth, strengthen border infrastructure and support progress in expanding the research base. The City of Toronto has started the all-important move of lowering the property tax burden on industrial and commercial properties. Yet the GTA's once formidable cost advantage has

been virtually wiped out by the 5-year run in the loonie. And with China and other developing markets expected to remain on a brisk growth path, there is unlikely to be any relief for the region from either a lower dollar or a sustained pull-back in commodity prices in the coming years. Nor is competition from these same developing market economies likely to abate. Some residents have taken comfort from the fact that the economy has still been able to churn out moderate growth over the past 5 years despite the ongoing fallout within the manufacturing sector. But as we have argued, a cyclical upswing in housing activity has helped to mask the impacts thus far – an effect that can't be counted on to continue indefinitely.

There are other new or existing challenges that will continue to complicate the road towards increased competitiveness. Since 2002, the need to reduce greenhouse gases and protect the environment has catapulted to the top of the region's priority list. With the environmental focus probably more than just the flavour of the day, there will continue to be growing demands on governments to better balance the goals of increased economic prosperity and sustainable development.

Meanwhile, significant resources in the GTA will continue to be absorbed by rising health costs or be drained away from the region in the form of income redistribution to other parts of Canada. Measures in the 2007 federal budget will reduce the net federal fiscal drag faced by the GTA – which had averaged a sizeable 4% of GDP between 1986 and 2002. Still, we raise the question of how much fiscal withdrawal is appropriate in today's age of increased global competitiveness.

We are encouraged that the GTA can meet the tall challenges before it, especially in light of the progress made since 2002. But, more than ever before, future policy actions will need to be underpinned by efficiency and innovation rather than new public money. For example, we call on the federal and provincial governments to enhance tax competitiveness by replacing the retail sales tax with a value-added tax. A greater tilt in the overall revenue mix toward user fees and sales/consumption taxes would allow more economically-detrimental taxes on income and capital to fall over time. And benefits can be found in the region turning to alternative or more innovative forms of service delivery, including public-private-partnerships (P3s)

Usually, times of challenge brings about strong leadership. We see a particular need for two players: the City of

Toronto and the private sector to step up and lead the charge. The City's flexibility has been limited by declining economic importance within the GTA and the existence of a large structural deficit. But while we urge the provincial government to upload a share of social service costs that were handed down to municipalities in the 1990s – the rationale being that these services are more appropriately funded off the income tax base – the City must do its job through efforts to better reallocate spending and emerge as a regional leader in terms of innovative program design and financing. Increased regional cooperation among municipalities could unleash benefits in the City and across the GTA. To that end, we are optimistic that the recent creation of the Greater Toronto Transit Authority (GTTA) by the province could mark a turning point, especially if endowed with similar revenue sources as those granted to the Greater Vancouver Transportation Authority. Tax increases should come lower down on the City of Toronto's priority list as a means of eliminating the budget shortfall. If applied, new taxes should be considered on the grounds of efficiency and achieving other social and environmental aims, rather than purely as a revenue grab.

Efforts to strengthen the GTA will run into a roadblock without increased participation from the private sector. The private sector needs to be more aggressive at taking advantage of new technologies and expanding research capacity to increase overall productivity. One of the benefits of a stronger loonie is that it lowers the cost of machinery and equipment imports. Yet total business spending on capital equipment in Ontario has increased at an anemic rate over the past half decade. China is providing tremendous possibilities for business expansion. But many companies in the GTA have yet to devise a China strategy.

In the 2002 GTA report, we highlighted the fact that business involvement in civic matters was crucial to the success of a city region. Happily, over the past five years,

many private sector players have made tremendous inroads on this front. In particular, the Toronto City Summit Alliance (TCSA) – with over 2,000 volunteers across business, non-profit, government and labour – has been a considerable force in bringing the public and private sectors together to spur positive change.

All GTA players must form a united front

Above all, cohesive and coordinated action among all the region's players is crucial in order to make significant strides. And, here, we see considerable cause for optimism. Consider the area of poverty, which is among the most complex challenges confronted in the GTA. This issue is also among the most pressing. Newcomers to the region not only suffer from high and rising incidences of low income, but they are staying there longer. And over the next 20 years, international immigration will likely be the area's sole source of population growth.

A particular challenge in confronting poverty in the City of Toronto is its self-perpetuating nature. The communities deeply affected by poverty tend to record high drop out rates at school and weaker academic performances. Few of the people the poor are in regular contact with have links to opportunity.

While improving credential recognition and helping to boost language skills are part of the overall solution, the best way out of this predicament over the long run is for government, business and community groups to come together to improve educational outcomes within the affected areas and to assist in the transition to work. On this front, there have been some exciting new cooperative initiatives over the past five years that have been bearing fruit, including "Pathways for Education", the establishment of the Toronto Region Immigrant Employment Council (TRIEC) and the Youth Challenge Fund. Building on these kinds of efforts will be essential going forward.

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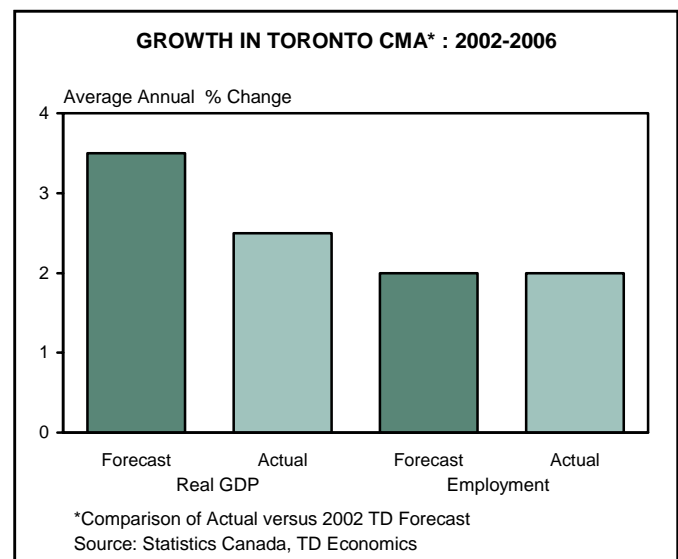
AN UPDATE TO TD ECONOMICS' 2002 REPORT ON THE GREATER TORONTO AREA (GTA) ECONOMY

Five years ago, TD Economics released a comprehensive report on the Greater Toronto Area (GTA) economy entitled *Canada's Primary Economic Locomotive In Need of Repairs* (www.td.com/economics/special/db0502_gta.pdf). The May 2002 report looked at the opportunities and challenges facing the country's largest urban market and outlined a policy prescription aimed at achieving sustained increases in prosperity for its residents. Earlier that year, TD Bank CEO A. Charles Baillie had put forward a goal to raise Canada's standard of living up to U.S. levels within 15 years. But without a prosperous and healthy Toronto region economy, we argued, Canada would slip even further behind.

In this *Update*, we provide an assessment of economic and policy developments since the 2002 study was issued. As we discuss on pages 10-23, governments have been chipping away at the region's key vulnerabilities over the past half decade. Yet the progress achieved on the policy side has been largely overshadowed by the emergence of a number of unexpected economic forces that have extended the relative decline in the GTA's standard of living against competing jurisdictions and added to the longer-term challenges facing the region.

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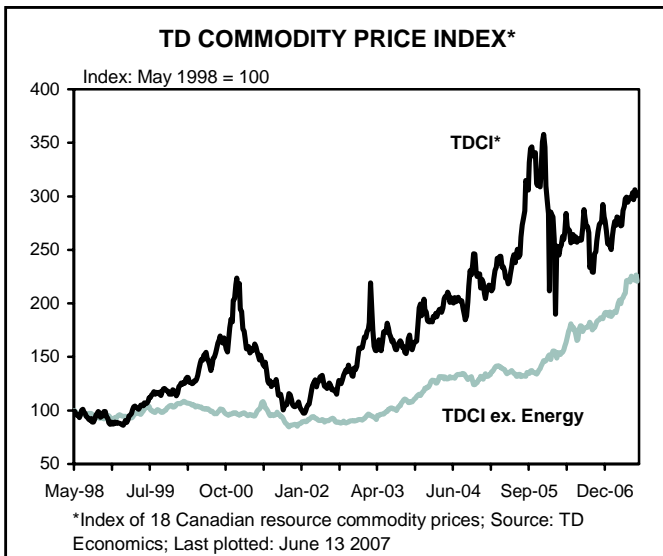


The post-2002 experience underscores the need for all public- and private-sector players in the GTA to re-double their efforts in combating some of the impediments to prosperity and quality of life. At no time has it been more critical for governments to align their goals and to look beyond traditional approaches to newer, more innovative models of delivering public services. We see an opportunity for two players in particular – the City of Toronto and the private sector – to step up and spearhead the charge.

We expected big things in the 2002-06 period

Rewind the clock back to 2002. The GTA economy was beginning to shake off the effects of the U.S. recession and implosion of the high tech bubble at the outset of the decade. With the U.S. economy poised to recover strongly and prospects brightening for export-oriented manufacturers, there appeared to be little stopping the GTA

The GTA economy is comprised of the City of Toronto and four regions – Durham, York, Peel and Halton – along with their constituent municipalities. Statistics Canada, which is the source of much of the data for this analysis, defines the region as the Toronto Census Metropolitan Area (CMA). The Toronto CMA aggregate excludes the GTA municipalities of Oshawa and Burlington. However, these cities are sufficiently small that the Toronto CMA data are considered a good proxy for activity in the GTA.



economy from racking up robust real economic growth of 3-3.5% per year and annual job creation of 2% during the 2002-06 period. What’s more, with the short-term path free of clouds, we argued that policymakers and leaders could focus their attention on dismantling the longer-term roadblocks to growth and prosperity.

GTA economy peppered with shocks

The U.S. economic revival would unfold as expected. However, a number of other developments would soon emerge that had eluded forecasters’ radar detection, including:

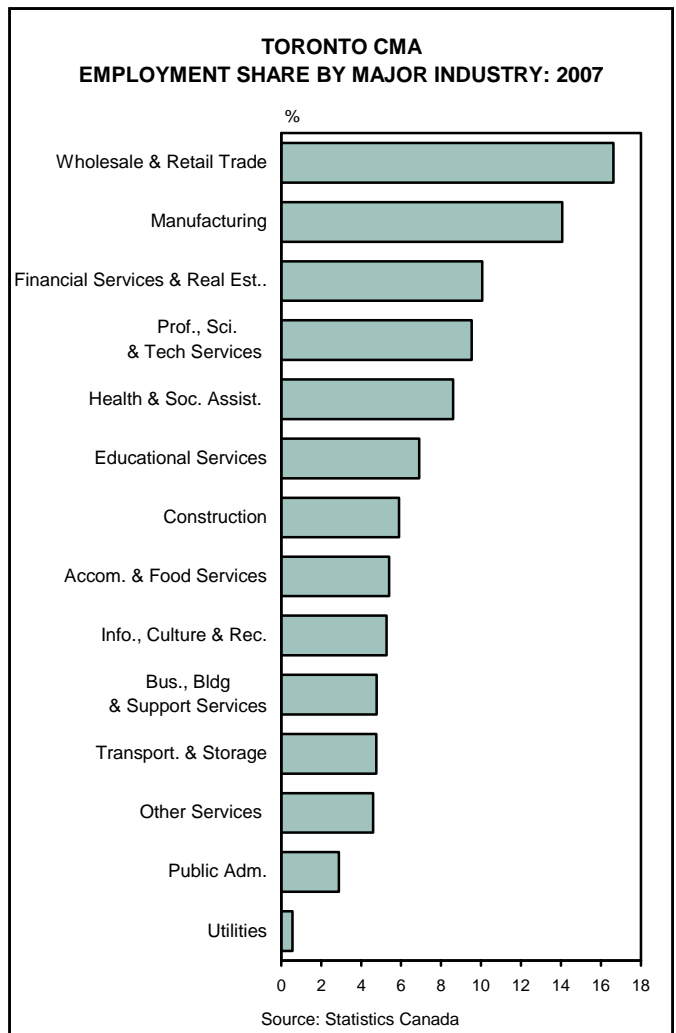
- The significant erosion in regional competitiveness due to a rise in the value of the Canadian dollar of nearly 50% vis-à-vis the U.S. dollar between mid-2002 and mid-2007.
- A tripling in the average price of commodities, including crude oil, natural gas and base metals. The GTA is a

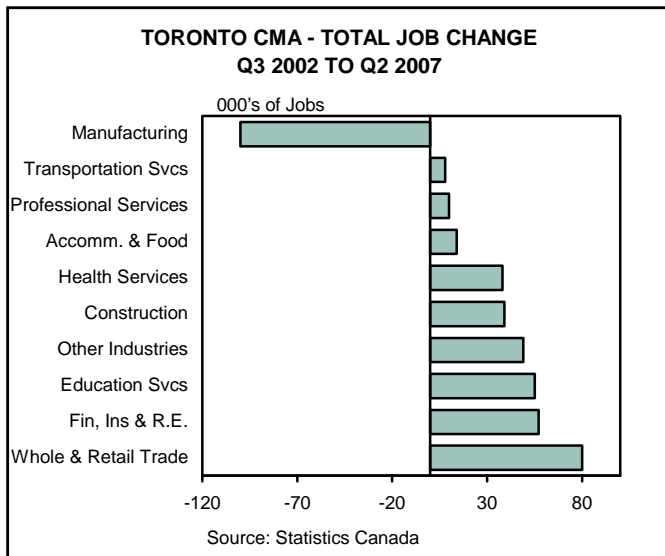
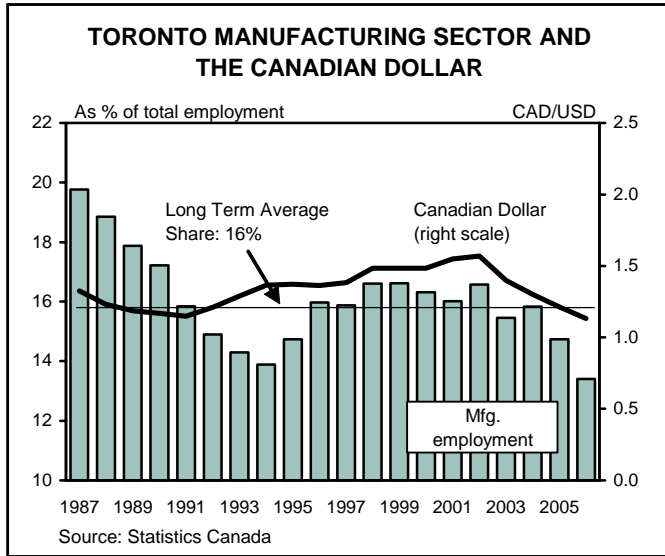
significant net importer of these goods, much of which are used as inputs into the manufacturing production process.

- While import competition from Mexico was a growing concern, China was not considered to be a short-term threat, especially for more sophisticated auto parts and other goods further up the value chain. However, pressures from Chinese competition have accelerated since 2002.
- A string of other unanticipated shocks temporarily disrupted economic activity in the GTA, including SARS and the Ontario power blackout of 2003.

A tale of two economies

For the roughly one-fifth of the GTA economy directly tied to the export-oriented manufacturing sector, these events would combine to form a perfect storm. And their



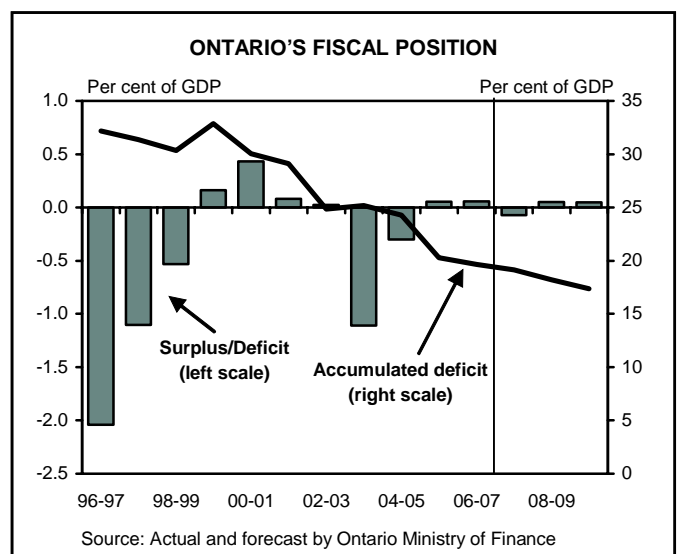


resulting impacts have been visible. Since the peak in mid-2002, net manufacturing employment in the GTA has fallen by about 100,000 positions (or about 20% of its pre-2002 workforce). Employment in the auto sector has dropped by more than 10,000 persons alone, with many of the region's parts producers feeling the added pinch from their close ties with the struggling Big 3 companies. In stark contrast, over the prior half decade, the sector had recorded a net gain of 100,000 employees.

Historically, when the GTA's manufacturing sector has sneezed, the entire regional economy has caught the flu. Yet over the past five years, the spill-over effects from declining factory activity have been surprisingly muted, as a number of other sectors have taken up some of the slack. The most important offsetting force has been the unusu-

ally low interest rates and the resulting boom in the housing market. Rising housing demand has been instrumental in driving up construction employment by about 40,000 positions over the past 5 years. But the effects of the buoyant housing market run much deeper. Statistics Canada estimates that a dollar in construction output translates into an additional \$0.76 of sales across other goods and service industries, with manufacturing, financial services and professional services among the largest beneficiaries.¹ As such, a meaningful proportion of the 150,000 combined employment advance in financial services, retail and wholesale trade and professional services can almost certainly be chalked up to housing-related demand for credit, home renovations and legal and other services. And without growth in housing sectors in the GTA and across the country, the softness in manufacturing activity would have been even more pronounced.

Toronto's financial, insurance, real estate and leasing sector alone accounted for job growth of 65,000 positions in the 2002-06 period. Supported by this recent wave of hiring, the number of jobs in Toronto's finance and insurance industry has reached almost 165,000 individuals or about one in seventeen economy-wide. (By comparison, the auto assembly and parts sector employs about 140,000.) As discussed in a June 2007 report by the Institute for Competitiveness and Prosperity, *Assessing Toronto's Financial Services Cluster*, this city-region is home to North America's third largest financial sector, behind New York and Chicago.² Furthermore, the financial services cluster is more important to the Toronto region economy than it is to any other regional economy in North America with the



GTA Tourism Activity Rising, But Market Share Still Declining

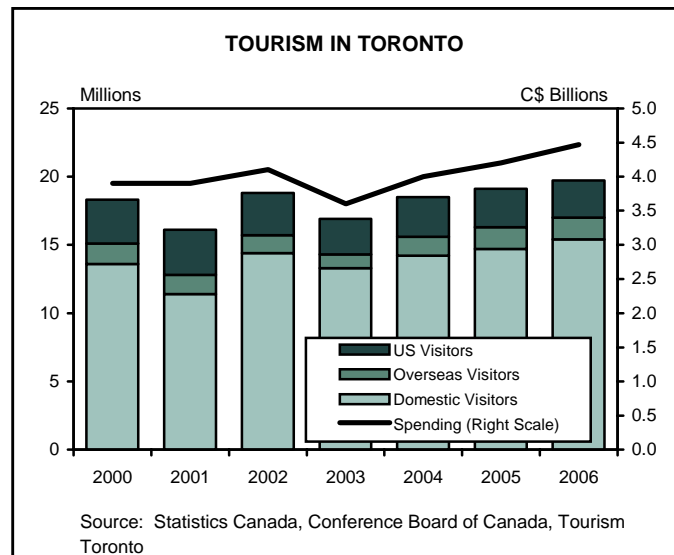
One of the focuses of our 2002 report was on the GTA's underperforming tourism industry, which had been on a structural decline. At 16 million in 2001, the number of visitors to Toronto was only half that recorded by the comparable city region of Chicago. We argued at the time that 20 million tourists would be a realistic interim target en route to a higher number.

Since the blow dealt by SARS in 2003, tourism activity in the GTA has turned the corner. Last year the number of visitors reached 19.7 million, only 300,000 short of our medium-term target. Moreover, total tourist spending bounced back from \$3.6 billion in 2003 to \$4.5 billion in 2006. While the rise in the Canadian dollar and elevated gasoline prices have kept the number of U.S. visitors below the pre-SARS level, this weakness has been more than offset by increasing domestic travel and visitors from overseas countries such as China and Korea. Keep in mind that the loonie has not appreciated to the same extent against most other currencies around the world.

Still, a better indication of how the city is faring is within the big city North American tourism market. On this count, Toronto's performance has been less stellar, with the city's market share of total domestic and international leisure tourism traffic to four locations (the others include New York, Boston and Chicago) falling from 20% in 2002 to 17% in 2006. In contrast, Chicago enjoyed a 4 percentage point jump, to 29%, while counts in both New York and Boston remained relatively steady at 39% and 15%, respectively.

In addition to the high-currency environment, the possibility that the U.S. government will impose a passport requirement on Canadian and American residents crossing the border by land or sea is a major concern to the Toronto tourism sector. (Canadians already require a passport to enter the U.S. by air). Recently, the U.S. Department of Homeland Security pushed back the implementation of the proposed law until mid-2008 and a further delay to 2009 appears likely. Still, the uncertainty remains a black cloud overhanging the industry.

For the GTA's tourism sector to continue to grow and strengthen its relative position in the North Ameri-



can market it must build on its recent efforts. Moves over the past few years to brand and promote the region, funded partly through the voluntary implementation by the hotel industry of a 3% destination marketing fee starting in 2004, appear to be paying dividends. In total, the fee raises about \$25 million per year for tourism marketing.

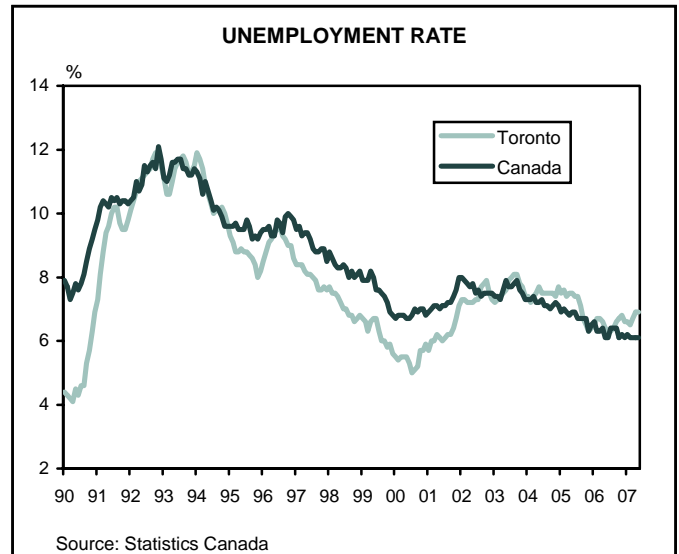
Another critical element of success will be the development of attractive destination sites. While the departure of the musical *Lord of the Rings* to London after a short stay at Toronto's Princess of Wales Theatre was a setback, there are other projects that should build on the recent momentum. Events such as Luminato - the Toronto Festival of Arts and Creativity launched by the Toronto City Summit Alliance and St. Joseph Communications CEO Tony Gagliano in partnership with many of the City's artistic leaders, and the Toronto International Film Festival have been successful in casting the spotlight on the City's cultural sector. The Michael Lee Chin Crystal at the Royal Ontario Museum, created by renowned Canadian architect Daniel Libeskind, has the potential to be a major drawing card by virtue of its originality and boldness. Lastly, the new opera house in Toronto and renovations to the Art Gallery of Ontario, which are expected to be completed next year, will provide additional support.

sole exception of Hartford.

There have been other pockets of the economy that have helped to cushion the blow from declining manufacturing employment. It may come as a surprise to many that the tourism sector has managed to emerge from a long downtrend over the past five years. As we point out in the text box on the previous page, few sectors have battled the same chillwinds as this sector, including SARS in 2003, the run-up in both the currency and gasoline prices and security-related issues at the U.S. border. Yet the number of visitors to the Toronto region bounced back to about 20 million visitors, about 25% above its recent post-SARS low set in 2003. While this rebound has been encouraging, the absolute numbers hide the fact that Toronto's tourism sector continues to lose market share against cities such as Chicago, Boston and New York.

The government sector has also provided stability to the GTA economy. While we had factored in moderate growth in public spending in our 5-year look ahead in 2002, the unveiling of a surprise \$5.6 billion deficit by the provincial government when it first took office in 2003 knocked this expectation for a loop. Nonetheless, the Ontario government has been able to eliminate its deficit gradually with relatively little short-term collateral damage to the GTA economy and other parts of the province. The success in eliminating the budget shortfall was made easier by a rise in federal transfers to provinces.

Lastly, in line with our projections, the population base of the GTA continued to grow at a vigorous pace over the past five years. Indeed, the 2006 Census revealed that the

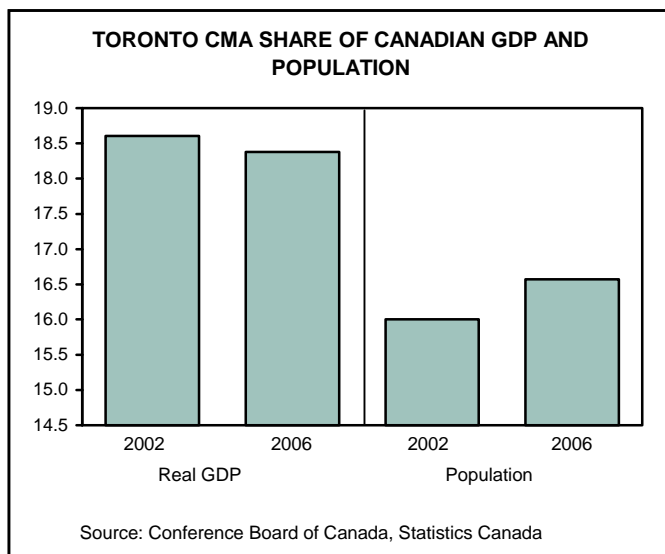


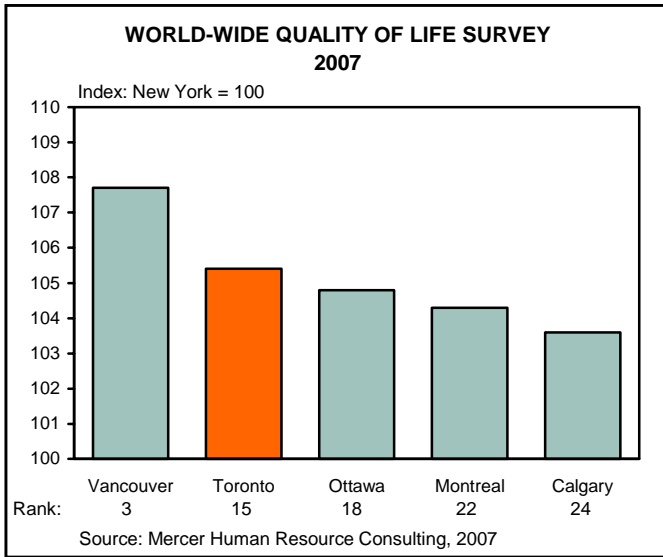
population of the GTA advanced by 9.3% since 2001, roughly in line with the pace recorded in the previous 5-year period. The major driver of the population increases remained international migration, with more than two-fifths of new Canadians continuing to make the GTA their home.

GTA output share down, population share up ...

In sum, the GTA economy has been able to register a moderate rate of expansion as it battles the various headwinds:

- Economic growth in the GTA ran at 2.5% per year in 2002-06, which is 0.5-1 percentage points lower than projected and 0.5 percentage points less than that recorded in Canada as a whole. In comparison, Calgary grew by about 5% per year followed by Vancouver at 3.4%. Montreal, which is Canada's other manufacturing centre, grew by only 1.7%.
- While output growth has fallen short of expectations, job creation has been bang on our call of a 2% annual average gain and in line with the national turnout. Still, the distribution of the job gains has been more geared towards the service sector and less towards the goods sector than we had anticipated.
- The unemployment rate in the GTA has dropped as expected – from 7.4% in 2002 to 6.5% in 2006. However, what has surprised us is the extent of the drop that has taken place in other Canadian markets, particularly out west. As a result, since 2003, the GTA's unemployment rate has risen above the national aver-



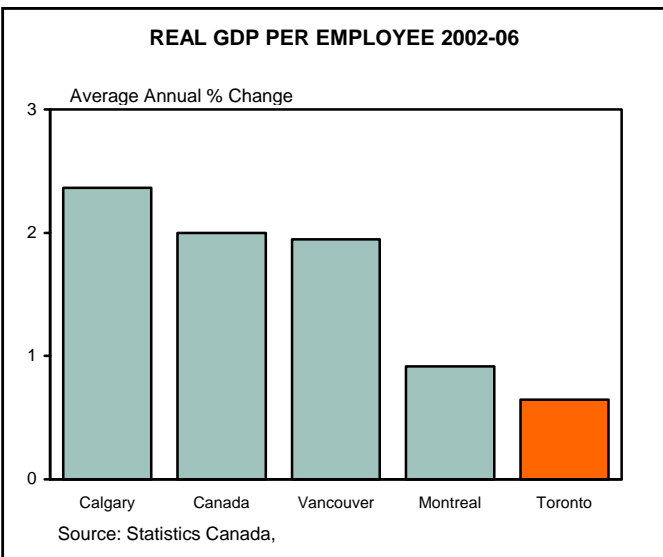


and leisure or other elements that determine the quality of life. There is a compelling argument, however, that a rising economic tide is critical to preserving and protecting quality of life through greater public resources and improved health, education and social services.

In 2002, the GTA scored well in virtually all international surveys of quality of life. Yet we were concerned that a wide gap had opened up between the standard of living in the GTA and the region's major competitors, particularly large cities in the United States. We were optimistic, however, that the period of strong growth over the next five years would help to reverse this trend.

Fast forward five years. The news emanating from international surveys on quality of life has remained favourable for the GTA. In 2006, Toronto ranked 15th of 215 cities on Mercer's Quality of Life Survey, up from 18th position in 2002.³ And earlier this year, FDI Magazine rated Toronto second to only Chicago in its *Top Cities of the Future* rankings, which took into account a range of economic and social metrics.⁴ In the quality of life sub-category, Toronto placed first.

Unfortunately, these impressive results in quality of life surveys have not been matched by a meaningful pickup in the GTA's standard of living, since the moderate increases recorded in real GDP have been diminished by a rising

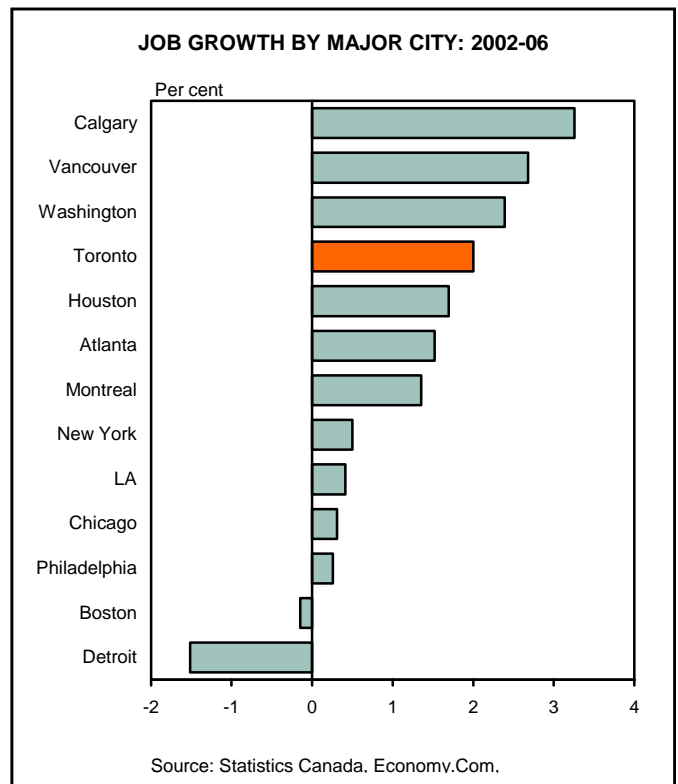


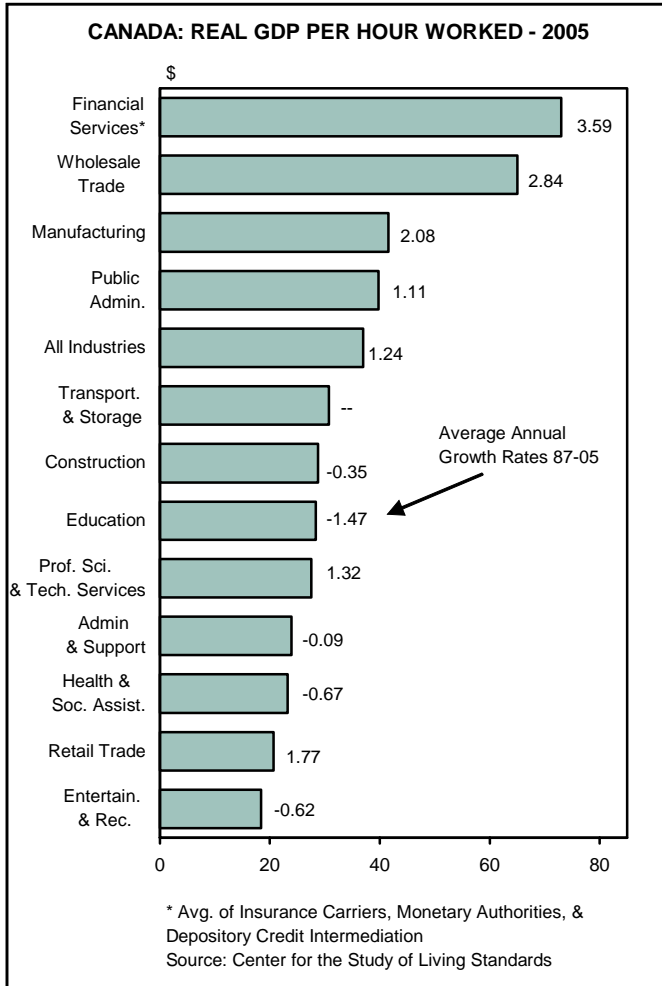
age for the first time on record.

- While the Toronto CMA's share of the national economy has edged down from 17.2% to 16.8% since 2002, its population share has increased from 16.0% to 16.5%, reflecting the ongoing immigration and the trend towards urbanization.

... but living standards slip further in relative terms

In 2002, we made the case that it was not absolute growth rates that mattered, but rather how they translated on a *per capita* basis. We have recognized that real GDP per capita is not a perfect measure of well-being, since it focuses on the activities that have a dollar value attached to them and does not factor in the trade-off between work





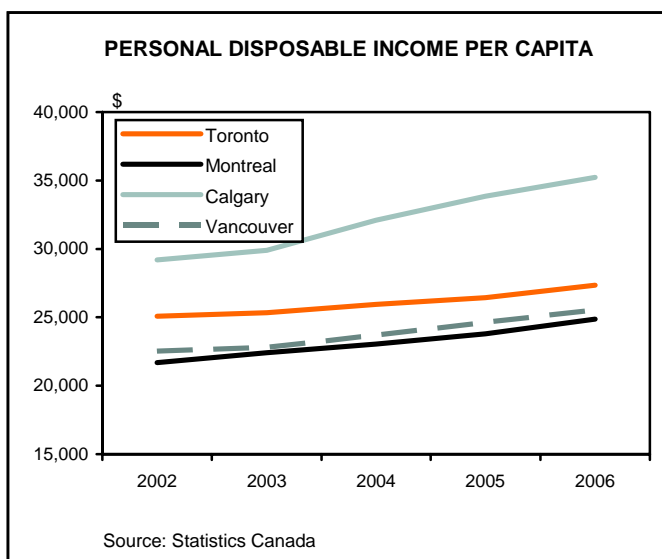
Even Montreal (0.9%) – which is another market that has faced challenges in manufacturing – eclipsed the GTA (0.5%) in per-capita output gains in 2002-06.

Although timely figures on U.S. metropolitan GDP are not readily available, a comparison of real personal income per capita provides another good proxy for prosperity. In 2002, the gap in real personal income per capita between the GTA and major U.S. city regions stood at about US\$7,500 (US\$27,000 versus US\$34,500). By 2006, this gap had increased to US\$8,500.

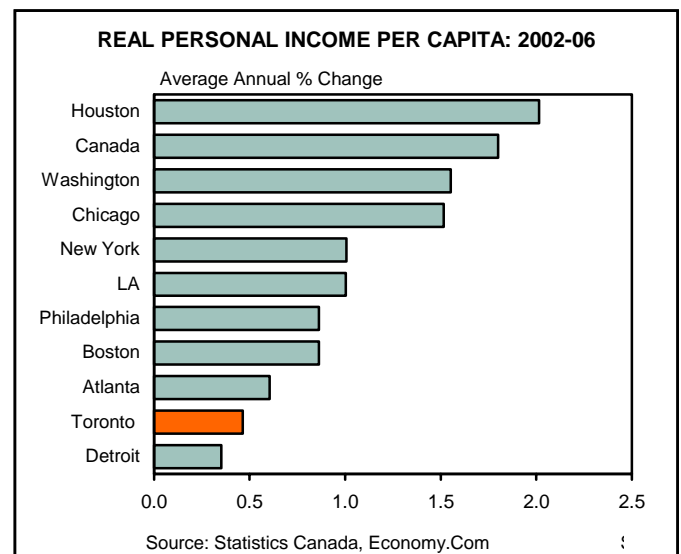
In the 2002 report, we argued that the weaker prosperity performance in the GTA was largely owing to lower productivity than in other city regions. This situation would only intensify over the past half decade. Although the GTA economy was a leader in terms of job creation among the major North American cities – placing second to only Washington – growth in output per employee was among the lowest, at a mere 0.5% per year. In most U.S. cities, average annual productivity growth ran above 2% per year, while even the GTA managed 2% growth in the prior 5-year period.

These findings are consistent with the work carried out by Ontario’s Institute for Competitiveness and Prosperity, which estimated that the gap in both productivity and overall living standards between the overall province and its 15 largest provincial and state competitors has widened since 2002.⁵ The Institute has determined that more than 80% of Ontario’s prosperity gap reflects lower labour productivity on a per hour basis.

An underlying factor behind the most recent deterioration in productivity growth in the GTA is the change in the



population. In fact, real GDP per capita in the region has increased at one-half the rate of the nation as a whole and one-third the pace of other large city-regions in Canada.

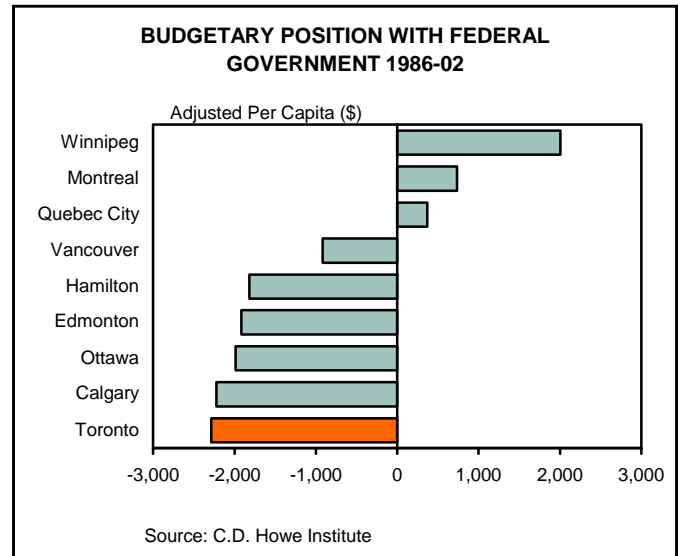


region's economic mix. Notably, the shift in the sectoral mix away from the manufacturing sector – which generates higher-than-average value-added per hour – toward a number of lesser value-added industries has put downward pressure on the economy-wide performance. But while the compositional change appears to account for a significant proportion of the slowdown over the last five years, it doesn't explain why productivity gains across most other industries have remained tepid. Rather, it is probable that many of the traditional culprits that were flagged in the 2002 TD report remain at play to varying extents.

How has the GTA measured up on the policy front?

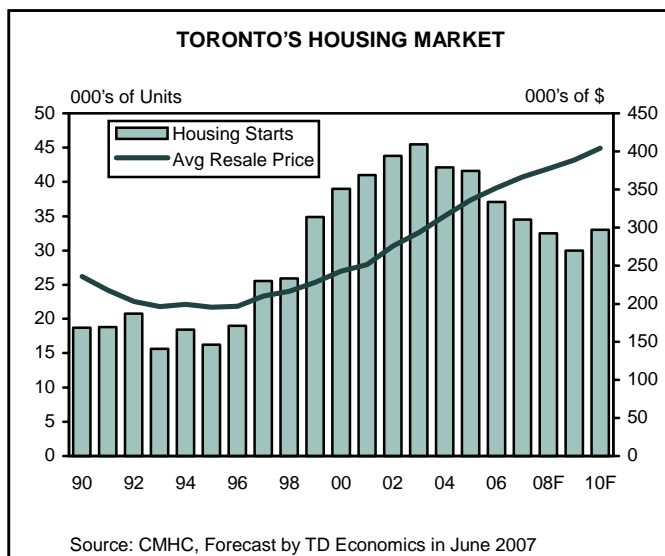
In 2002, we argued that there were 6 critical policy areas that would need to be addressed if the GTA was to turn around its sagging productivity and prosperity performance: competitiveness, education, urban sprawl, poverty, infrastructure, and municipal finance. The inability of the GTA to make progress in narrowing the prosperity gap over the past five years should not be interpreted as an abject failure of leaders in the region to tackle these issues. Instead, as we discuss in the following section, there has been plenty of good news on the policy front, since most of the policy areas have featured prominently in recent government budgets. In any event, the benefits of positive structural change don't tend to be immediately visible, especially during periods of major economic adjustment.

Before we delve into the recent developments across the various policy areas, it is important to reiterate the monumental shift in the landscape that has occurred over the



past half decade. We have already alluded to the perfect storm that has brewed over the manufacturing sector. The growing consensus is that the storm clouds not only have considerable staying power, but will unleash even greater impacts on the economy over the foreseeable future. There is unlikely to be any relief for manufacturers from either a lower dollar or a sustained pull-back in commodity prices with the Chinese and Indian economies projected to remain on a blistering growth path. Nor is the competitive threat from manufacturers in lower-cost jurisdictions, notably China, likely to recede. Instead, the pressure will probably intensify as producers in developing markets move further up the value-added chain (see text box on next page). Lastly, low interest rates and a booming housing market have helped to mask weakness in manufacturing by generating demand for construction-related products and propping up overall economic growth. However, it is unlikely that the region can count on this masking trend for much longer. In fact, housing starts in the GTA have already appeared to have peaked in the current cycle.

While the challenges in manufacturing have been stealing much of the spotlight, other issues have garnered increasing attention. Since the 2003 power blackout, worries about possible power shortages in the province have moved to the centre. And more recently, the importance of reducing greenhouse gases and protect the environment has catapulted to the top of Ontario's priority list. In a 2007 TD Economics report entitled *Market Based Solutions to Protect the Environment*, we pointed out that the trade-off between the environment and the economy can be mitigated through smart policy design. With the envi-



Manufacturing Under Siege

China leaving its mark on manufacturing in the GTA

The manufacturing sector in the GTA and elsewhere in the Province has been losing ground in recent years, and especially to producers in China. Of the 3 percentage point deterioration in Ontario's trade balance (as a share of GDP) over the past decade, two-thirds has occurred against China. In turn, two-thirds of the trade slippage against China was in manufacturing, particularly in the capital intensive areas. Ontario's imports from China have shot up from 0.7% of provincial GDP in the mid-1990s to 2.8% today.

Going forward, the greatest threat to the GTA is the quick movement of Asian producers up the value-added chain, as producers continue to benefit from cheap labour (average salaries ranged from US\$1,000-US\$1,500 in 2003), economies of scale and lenient environmental standards. For example, five years ago China was a non-entity in the North American auto parts industry. Now, 5% of North American auto parts originate from China. Keep in mind that China's progress into many sectors will not occur overnight, as firms there still face significant barriers to entry, including a perception of inferior goods, a lack of technical management competencies and limited R&D and innovation. However, the risk is that China will successfully overcome these impediments in the years ahead.

GTA not alone

It is also important to note that the Toronto region is not alone in experiencing a wave of imports from emerging markets. Since 1997, the share of Canadian imports from non-OECD countries has soared from 8 to 14%. For example, Montreal's manufacturing industry has witnessed Chinese competition extend from textiles to other areas, including pharmaceuticals and newsprint.

And nor is the GTA an exception to the rule in confronting shrinking employment in manufacturing. In countries such as the United Kingdom, Germany, France, Italy, Japan and Australia, manufacturing employment has been trending down since the 1990s or early 2000s, while in

ONTARIO'S TRADE BALANCE IN GOODS			
AS PER CENT OF ONTARIO'S GDP			
	1996	2005	Change*
Total	-4.3	-7.4	-3.0
China	-0.5	-2.5	-2.0
Total manufacturing	-0.2	-1.8	-1.6
Capital-intensive	-0.1	-1.4	-1.3
Other	-0.1	-0.4	-0.2
Other goods	-0.3	-0.7	-0.4
Other countries	-3.8	-4.9	-1.1

*May not add due to rounding; Source: Statistics Canada

the U.S., the structural decline has been in place since 1979. In Montreal – Canada's second largest industrial centre – the high water mark was reached in 1999. Still, few markets around the world have experienced greater declines in factory jobs since mid-2002 as Toronto and Montreal, where about one-fifth of total workforces have been shed.

A new wave of U.S. competition

The GTA's manufacturers are not just facing enormous challenges directly from China, but indirectly through competitive pressures that are spilling over to wage structures in the United States – a development we often refer to as the "Delphi effect". When the Delphi auto parts workers were part of General Motors, the base wage for workers was about US\$40 per hour. When GM spun off Delphi, wages were cut to US\$27 per hour, before the company fell into bankruptcy protection in 2005. At present, in order to exit bankruptcy protection, Delphi is pushing for union concessions to knock the base wage rate to around US\$16-17 per hour and to cut back benefits sharply to improve its competitiveness.

In some industries, there are also competitiveness challenges from foreign-based companies that aren't saddled with the pension and medical legacy costs, as well as from workers in the U.S., particularly in the south, who are accepting lower wages and benefits. Over the long run, well-paying manufacturing jobs can only be sustained through increased productivity.

ronmental focus probably more than just the flavour of the day, there will continue to be growing demands on governments to better balance the goals of increased economic prosperity and sustainable development.

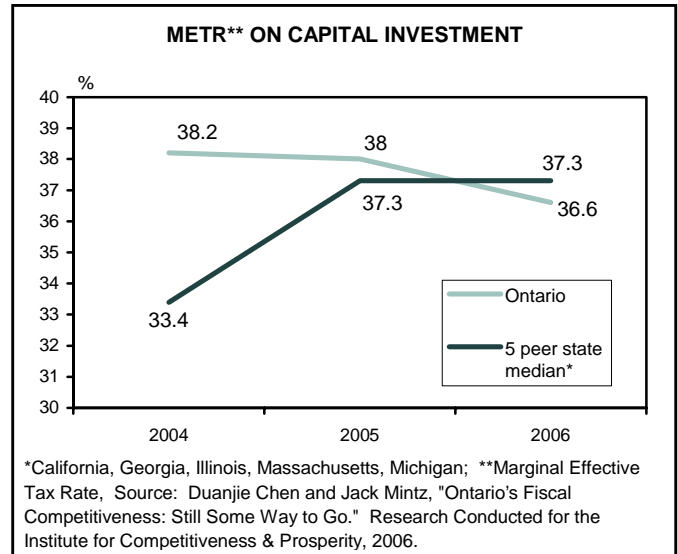
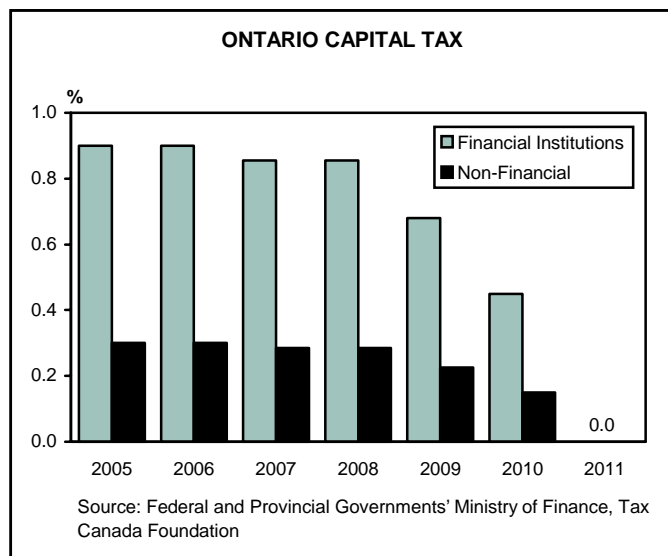
Complicating matters even more, some of the longer-standing strains on the economy have either remained in

place or intensified, hence stifling the amount of measured progress in raising prosperity. The relentless upward climb in healthcare costs hasn't let up, with health spending now absorbing 42% of the overall provincial discretionary budget. At the same time, resources have continued to drain from the region on a net basis. A recent CD Howe study esti-

mated that, during the 1986-2002 period, residents of the Toronto region contributed an average of \$2,285 per person more to federal coffers than they received in the form of federal spending.⁶ This deficit amounts to an annual fiscal drag of 4% of GDP. The figures in the CD Howe report only cover the period up until 2002, so they wouldn't factor in the subsequent federal moves to improve fairness in the transfer system. Most importantly, in the 2007 federal budget, it was announced that cash transfers under the Canada Social Transfer (CST) and Canada Health Transfer (CHT) would be allocated on an equal per-capita basis in 2007-08 and 2014-15, respectively. Still, even with these changes, the number likely remains significant.

While some net federal withdrawal from the GTA can be easily supported on the basis of higher-than-average incomes compared to the Canadian average, the bigger question is how much redistribution is appropriate in today's environment of stiff global competition. Keep in mind that the GTA is not alone in confronting this phenomenon. Higher-income U.S. cities such as New York, Chicago and Los Angeles also face a large federal fiscal withdrawal.

These important post-2002 developments have not diminished the importance of addressing the six broad challenges that we tackled in the original study. If anything, they have heightened the need for the public and private sectors to move along consistent policy paths in order to raise the overall effort. As we argue below, in some of the areas – such as taxation – a lack of coordinated policy direction by different players has held back the extent of progress.



(1) Cost competitiveness

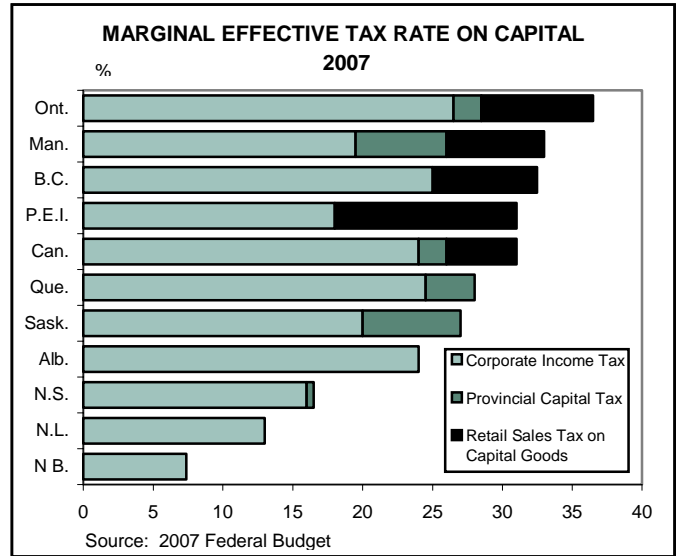
The first major challenge we identified in 2002 was competitiveness. At the time, we cited relatively low business costs as a key competitiveness advantage for the GTA, but warned that too much of the edge rested on the weak Canadian dollar, which traded below 70 U.S. cents. Not surprisingly then, the subsequent surge in the loonie has put a serious dent in the region's competitiveness. Based on figures released by KPMG, the Toronto region still enjoyed the third-lowest business costs among 22 large North American cities in 2006.⁷ But over the past five years, the gap had whittled down from 13% to only 4%. And that cost difference was based on an 85 U.S. cent dollar. So far this year, the currency has climbed well above 90 U.S. cents, suggesting that the modest prevailing cost advantage has now evaporated.

The negative impact on the GTA's competitiveness from the loonie's ascent would have been much more pronounced had it not been for a number of counterbalancing factors. Many companies in the region have reaped rewards from a drop in the Canadian-dollar price of U.S.-made capital goods or other inputs in the production process. In the case of import-intensive sectors, such as wholesale and retail trade, the high currency have bestowed perhaps the greatest benefits. Meanwhile, some of the costs that absorb a large share of company budgets, such as wages and office rents, have been growing more slowly in the GTA than in other major U.S. cities.

An improvement in GTA's business tax position has been another factor that has provided some offset to the cur-

rency-related pressure. Some of the key highlights include:

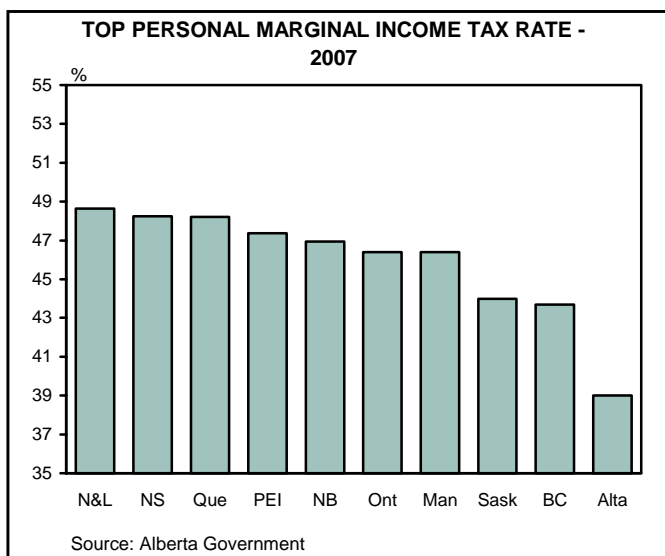
- Since 2002, the federal government has cut its corporate income tax rate (CIT) from 25% to 21% and eliminated the Federal Large Corporations Capital Tax. In 2008, the federal government will eliminate its CIT surtax and will reduce the CIT rate further, to 18.5%, by 2011.
- In the 2007 budget, the federal government announced changes to the capital cost allowance (CCA) rules that will allow manufacturers to write off over two years machinery and equipment purchases made before 2009. The provincial government paralleled these measures, delivering \$400 million in combined tax relief over the next three years.
- With the provincial government focusing on deficit elimination, tax relief has been pushed to the back burner. In fact, just after taking office, the McGuinty government cancelled a planned reduction in the province's CIT from 14% to 12.5%. Since then, however, there have been some positive developments on the provincial front, including a legislated commitment to eliminate all capital taxes by July 1, 2010, and an announced \$540 million reduction in business education property taxes.
- Last year, the federal and Ontario governments entered into an agreement to harmonize the federal/Ontario corporate income tax systems. This move will save businesses \$90 million per year in income taxes and up to \$100 million per year in compliance costs.
- As we discuss on page 16, the provincial non-residential education property tax reductions are being comple-



mented in the City of Toronto by efforts to lower the municipal business property tax burden.

As a result of these moves over the past few years, Ontario's marginal effective tax rate (METR) on capital investment – an all-encompassing measure of taxation that includes levies on income, capital and purchases of business inputs – has fallen from 38.2% in 2004 to 36.6% in 2006.⁸ Moreover, the rate is slated to remain on a downtrend over the next few years as the already-announced reductions are implemented. Although Ontario has continued to lose ground in business tax competitiveness with jurisdictions in western Canada, the province has been opening up a favourable gap with U.S. states. And with the U.S. federal government running a deficit position, a further widening in this Ontario-U.S. corporate tax gap appears to be a good bet.

Personal income tax (PIT) rates also factor into business competitiveness through their role in attracting talent to the region. At 46.4%, Ontario's top marginal PIT rate has held steady at its 2002 level, leaving it hovering some 2-7 percentage points above rates in Alberta, B.C. and Saskatchewan. When compared to some competing U.S. states, this differential rises to about 10 percentage points, while Ontario's top rate continues to kick in at a threshold more than US\$200,000 lower. Other news on the PIT front has been mixed. In its 2004 budget, the Ontario government introduced a health premium levy that rises to a maximum of \$900 at income levels above \$200,000. On the flip side, both the federal and provincial governments have cut their rates applicable to dividend income.

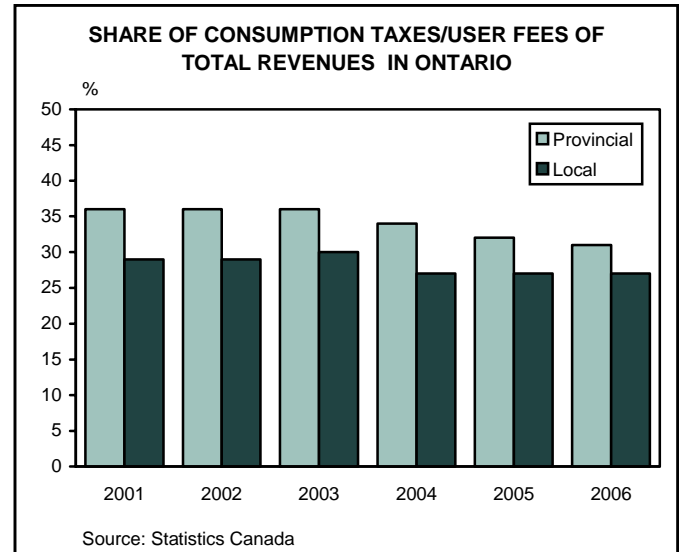


Other targeted government policies have provided support to the region's business community. For example, in reaction to the subsidies game that is being played out in southern U.S. states, the Ontario government developed a \$500 million Automotive Investment Strategy (AIS) in 2004 that has been successful in attracting some \$7 billion in new automotive investment in the GTA and surrounding Ontario regions. In June 2007, the Province announced in June 2007 that it would establish a \$650 million fund modeled after the AIS which will aim to attract investment in environmentally-friendly technologies within the auto sector. These strategies, which focus on research activities, should help to improve the sector's long-term viability.

Progress in expanding the research base in the GTA has been achieved more broadly over the past five years. Two notable examples include the establishment of the Toronto Region Research Alliance (TRRA) and the rapid development of the MaRS Discovery District, which has brought science and technology researchers together under one roof with business and investment capital firms. The TRRA is a public-private partnership that also focuses on building research and commercialization activities and to attract new research-intensive companies to the region. In the second phase of development, MaRS announced in June 2007 that it had selected Alexandria Real Estate Equities Inc. as partner to construct a 900,000 square foot state of the art office, laboratory and technology space to anchor the City's biomedical corridor in the Discovery District.

Putting it all together, initiatives undertaken since 2002 have marked a step forward in improving the GTA's competitiveness over the past half decade, but the emergence of external forces such as the strong Canadian dollar has taken it a few steps backwards. As noted, high commodity prices and currency threaten to further erode the cost picture. As such, the region must work even harder to create a distinct competitive advantage over the long run. A number of key priorities over the next half decade should be:

- *More efficient taxation (all levels)* – the over-riding goal of all orders of government should not only be to reduce the overall bar, but to raise revenues more efficiently. At the federal and provincial levels, a greater tilt in the overall revenue mix toward user fees and sales/consumption taxes would allow more economically-detrimental taxes on income and capital to fall over time.

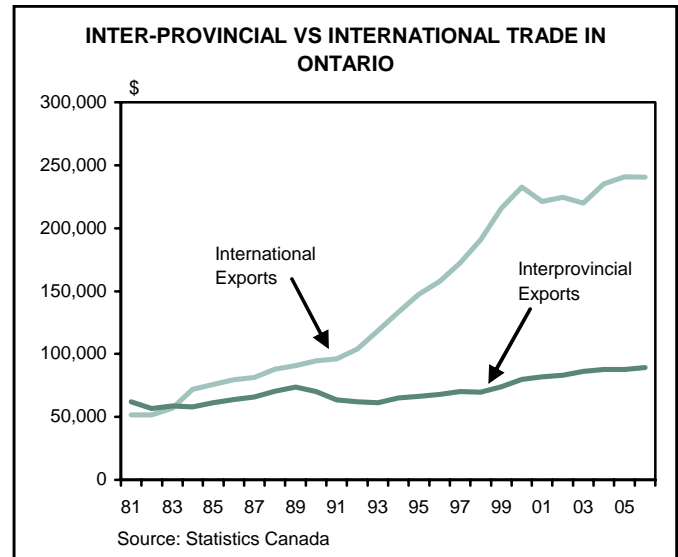


At the local level, a similar case can be made in favour of shifting the balance of revenues from property taxes, which account for more than 60% of the own-source take in the average Ontario municipality, to user fees. (Non-residential properties in the GTA, in particular, face an outsized burden compared to the share of local services they receive.) While the user-pay approach is criticized for being regressive in nature, these moves could be complemented by mechanisms that help individuals most in need. Moreover, user-pay would be consistent with the goal of encouraging conservation and improving the environment.

- *Replace retail sales tax (RST) with value-added tax (provincial/federal)* – we congratulate the federal and provincial governments for eliminating capital taxes, which are among the greatest impediments to investment and productivity. Another major roadblock that remains is the provincial retail sales tax levied on purchases of capital goods and other business inputs. Currently, only manufacturers are exempt from RST on certain purchases. This impediment could be addressed by replacing the provincial sales tax with a harmonized goods and services tax (GST). A less-preferable route would be to implement a system such as that in Quebec, where full harmonization has not taken place but where the PST has been structured to match the GST. The federal Department of Finance has estimated that if Ontario were to eliminate the retail sales tax on capital good, Ontario's METR would tumble by a substantial 9 percentage points, knocking it from the highest among

the provinces to among the lowest.

- *Strengthen electricity position (provincial)* – The Ontario government must stay the course in its 20-year plan to address the risk of looming shortages in the supply of power. In order to replace the power from coal-fired generators (which are slated to be shut down by 2014) and to close the status-quo supply-demand gap, the government is banking on securing new sources of electricity, with an emphasis on nuclear power. These measures to build new supply must be complemented by those to strengthen power infrastructure, including transmission capacity to the downtown and other parts of the GTA. A particularly tall task will be to achieve the improvements in demand-side management that are assumed in the government's long-term plan, since progress in encouraging conservation has been marginal at best. Continuing to raise residential power prices to better reflect the true marginal cost would be an effective tool in restraining demand.
- *Enhance international trade opportunities (federal)* – In effort to ensure that Canada's manufacturing and export-oriented industries remain an important contributor to national income, more must be done to enhance international trade opportunities. Prior to the free-trade agreement signed earlier this month with four European Countries (i.e., Liechtenstein, Iceland, Switzerland and Norway), Canada had not inked a deal since reaching one with Costa Rica in 2001. Success in reaching agreements with the European Union and the Americas would be much more important milestones for both the GTA and Canada. But while free trade agreements generate potential benefits, they can also raise risks, particularly in some sectors. For example, there is concern that a deal with South Korea would negatively impact the region's auto sector.
- *Address Canada-U.S. border issue (federal/provincial)* – Since 9/11, heightened security and passport requirements implemented by the U.S. government have become an increasing barrier to cross-border flows. Congestion at the region's numerous border crossings remains a significant problem. Although funds have been set aside by the federal and provincial governments to improve border infrastructure in recent budgets, setbacks continue to arise in the construction of a new Detroit-Windsor bridge and in negotiating pre-clearance.



Efforts must be stepped up to address these obstacles.

- *Follow B.C.-Alberta lead in inter-provincial trade (provincial)* – Perhaps the greatest opportunities for trade exist at home. Last year, Alberta and British Columbia established a framework and timetable that will knock down provincial barriers and create a market larger than Quebec's. Ontario should explore opportunities to sign on to the deal or something along the same lines with neighbouring Quebec. Lastly, we urge the provincial government, along with its federal counterpart, to continue to press other provinces for the creation of a national securities regulator.

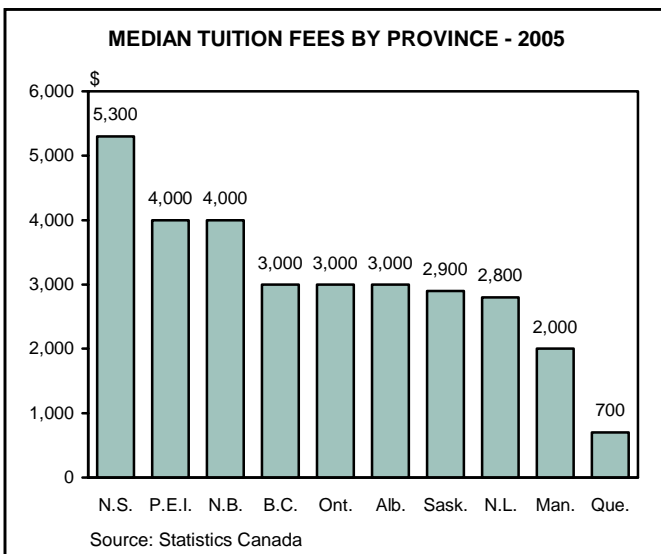
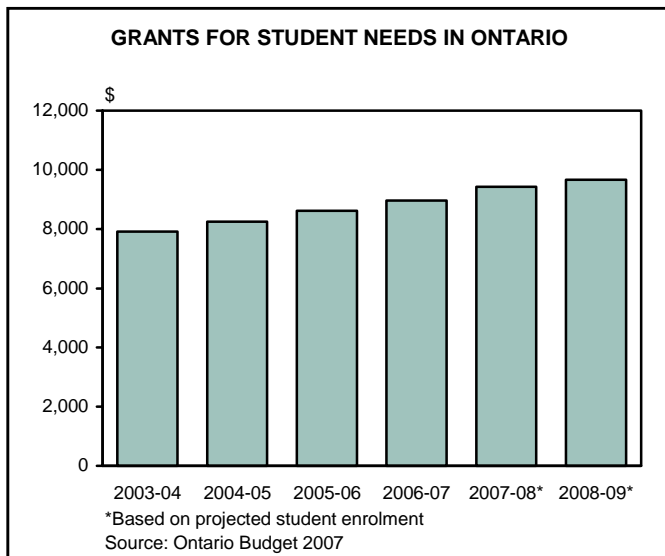
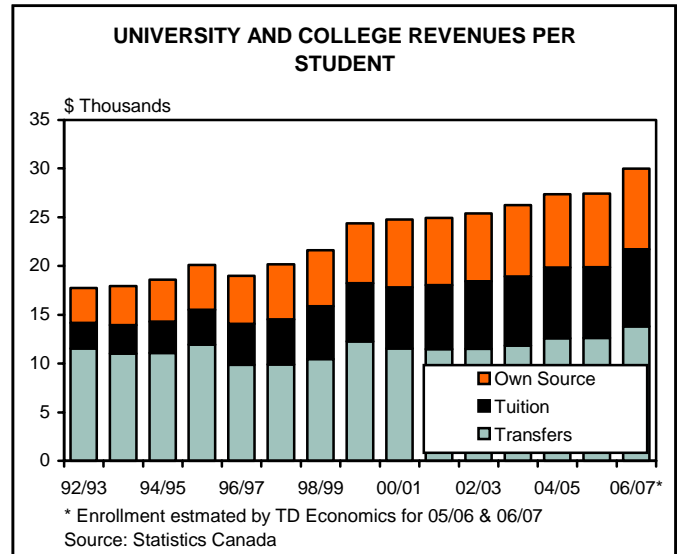
(2) Education and Skills

Among the various challenges facing the region, the education area has recorded one of the most notable turnarounds, at least in terms of government attention and new resources. Funding per student in post-secondary education (PSE) had fallen steadily in the 1990s. The 2004 Ontario budget, however, delivered multi-year plans to reinvest in cash-starved PSE institutions. Between fiscal 2003-04 and 2007-08, combined operating grants to colleges and universities have been increased from \$2.9 billion to \$4.0 billion. The government has also re-introduced upfront grants and limited student debt to \$7,000 per completed year of study.

Some of the benefits to the PSE sector of the funding increases were offset by a two-year tuition freeze that was implemented in fiscal 2004-05 and 2005-06. In addi-

tion, PSE institutions have faced a one-third increase in enrolment following the elimination of grade 13 in 2003. Despite these developments, funding per student has still managed to rise considerably over the past half decade. And in 2006, the government lifted the tuition freeze, allowing PSE institutions to raise fees an average of 5% per year in fiscal 2006-07 and 2007-08.

Provincial spending in the public school system has also been climbing – from an estimated \$7,920 per student in 2003-04 to \$9,670 by 2008-09. Class sizes have been scaled back over the past few years and student testing scores have increased. In particular, the percentage of grade 3 and grade 6 students in Ontario achieving provincial standards in reading, writing and math has climbed from 54% to 64% since 2002.



On the immigration front, changes have been made to the federal selection process in recent years, with increased focus being placed on economic immigrants rather than family reunification. As part of the 2005 Canada-Ontario Immigration Agreement, the federal government will spend more than \$1 billion over six years on immigrant settlement and language training. The Province will have flexibility to nominate foreign individuals for permanent residence based on labour-market priorities.

In sum, the GTA has taken some positive steps since the release of the 2002 study to strengthen its labour force. Still, there remains considerable work to do in building a skilled workforce to combat the challenges of an aging population and globalization, with policy hopefully taking aim at some of the more complex challenges:

- Over the medium term, PSE enrolment is likely to rise further in light of continued rapid immigration flows and the ongoing impact of the echo generation. This increased enrolment, while a positive development, will continue to place strains on the resources of universities and colleges.
- The high school drop-out rate remains stubbornly high. While the graduation rate from high schools has improved since 2003 – from 68% to 73% – there is still a way to go to meet the government’s target of 85% by 2010-11.
- Educating and integrating immigrants into the GTA workforce will remain perhaps the toughest single task. Moves to boost funding for ESL teachers in public

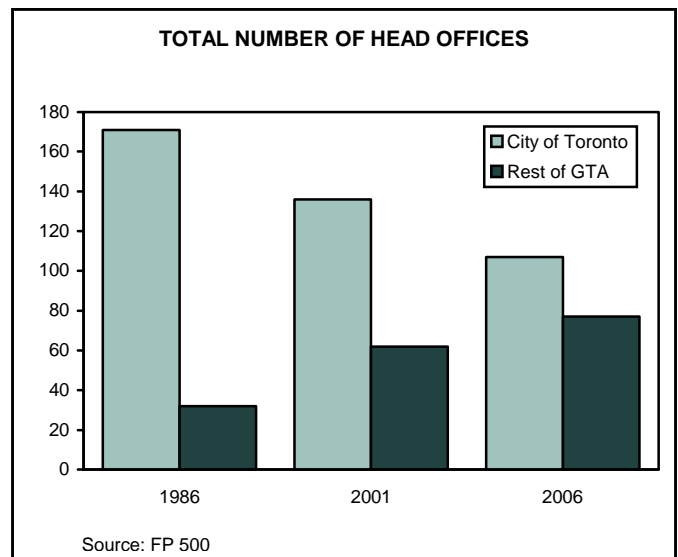
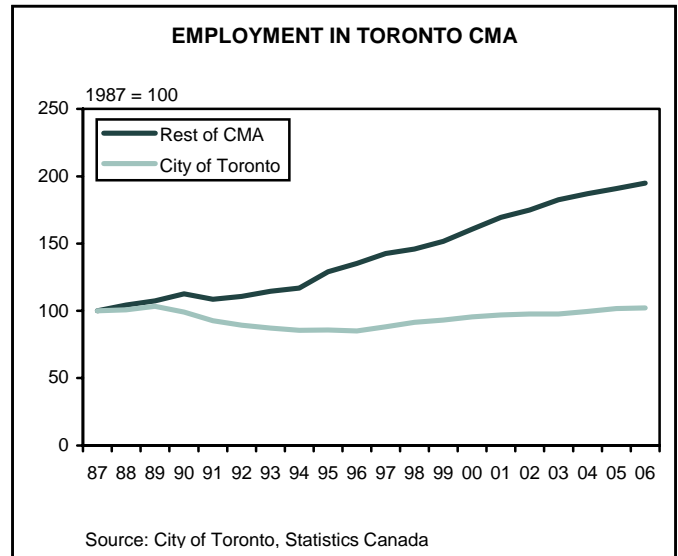
schools, developing programs that involve both parents and the community in the school system and supporting the efforts of public-private groups such as the Toronto Region Immigrant Employment Council (TRIEC) will become increasingly critical. We discuss the challenges faced by newcomers in more detail in section (4).

(3) Urban sprawl

Our 2002 study went to some length to discuss the growing problems of urban sprawl in the GTA. Although we recognized that it was natural that the population of the higher-density City of Toronto would grow at a slower rate than those of the lower-density surrounding areas, we noted that the massive gap in growth rates was problematic since it would lead to increased congestion and raise the cost of delivering public transit and other services.

The 2006 Census confirmed that sub-urbanization continued apace over the past half decade. Population in the 905 area code advanced by a blistering 19% – up from 16% in the 1996-01 period – while the head count in the 416 area code slowed from 4% to virtually nil. Even within the 905, however, the growth patterns continued to move further out in the periphery. Some of the older suburban cities recorded below average growth, including Pickering (0.9%), Mississauga (9.1%) and Burlington (9.0%). In contrast, Vaughan, Markham and Brampton all posted population gains of more than 25%.

While the higher City of Toronto real estate costs continued to be a factor driving individuals to the relative affordability of the suburbs, many residents were follow-



POPULATION OF THE GREATER TORONTO AREA (GTA)				
	Population	Population Growth Compound Annual Rates		
		2006	96-01	01-06
GTA	5,555,912	1.9	1.8	1.8
City of Toronto	2,503,281	0.8	0.2	0.5
Durham Region	561,258	2.0	2.1	2.0
York Region	892,712	4.2	4.1	4.2
Peel Region	1,159,405	3.0	3.2	3.1
Halton Region	439,256	2.0	3.2	2.6
Rest of Ontario	6,604,370	0.7	0.9	0.8
ONTARIO	12,160,282	1.2	1.3	1.2
CANADA	31,612,897	0.8	1.0	0.9

Source: Statistics Canada, TD Economics

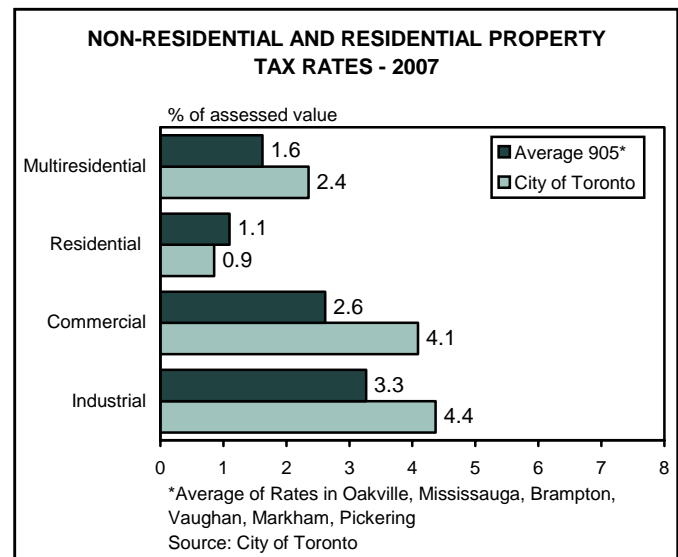
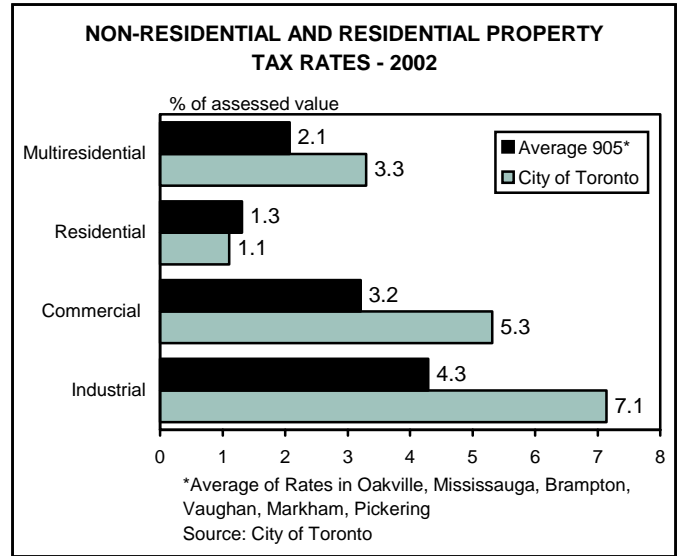
ing the flow of head offices and jobs. Data from the Financial Post FP 500 reveal that Toronto continues to lose head offices to the suburbs.⁹ Between 2001 and 2006, the number of head offices in the City slipped from 136 to 107, while in the rest of the GTA they rose from 62 to 77. There has been some good news in the City since 2002. Employment has begun to recover after falling in the late 1990s, while over 3 million of Class A office space under construction in the downtown core. Still, employment growth and overall business activity continues to expand at a considerably slower rate than in other areas of the GTA and well short of that projected in the City’s Official Plan. In fact, based on City of Toronto estimates, employment by place of work in the rest of the Toronto CMA surpassed that of the City in 2006 for the first time on record. (In the

case of real output, this cross-over occurred a year earlier). Over the 2002-06 period, the City of Toronto posted average output growth of 07% compared to 4.2% in the rest of the CMA. And, at an estimated 8.1%, the average unemployment rate in the City of Toronto over the past five years was not only leaps and bounds above the 6.4% average in the 905 area, but a full percentage point above the Canadian average. Although the GTA is often viewed as one large economic locomotive, the region is increasingly becoming a tale of two economies.

In 2002, we cited the large property tax differential between business property tax rates in the City of Toronto and suburban areas as a chief culprit in driving jobs from the downtown and dampening the non-residential tax assessment base. On a bright note, this differential has narrowed significantly over the past five years, owing in part to cuts implemented by the City. In 2007, the gap between commercial rates in the City of Toronto and in surrounding areas stood at about 1.5 percentage points – down from 2.1 percentage points in 2002 – while the difference in industrial rates has been chopped from 2.8 percentage points to 1.1 percentage points. In contrast, the City of Toronto has traditionally had lower residential tax rates. And this advantage grew slightly between 2002 and 2007.

Looking ahead, the City of Toronto hopes to make further headway in improving its business tax competitiveness and in achieving a more equitable split between residential and non-residential burdens. In late 2005, Toronto City Council approved a plan that will lower the ratio of industrial, commercial and multi-residential property tax rates from 4.0 times to 2.5 times the residential rate by 2021. Nonetheless, the City’s progress will continue to be measured in terms of how its business rates compare to those in the surrounding jurisdictions. And, on this count, the Ontario government’s longer-term commitment to lower education property tax rates will benefit the City’s business tax position more than in the 905 region. The Province estimates that, once fully implemented, City businesses will save \$230 million annually in education taxes.

Although market forces have continued to play a role in fuelling urban sprawl, development planning is another critical element. Since 2002, there have been some positive achievements in this area, including changes made to the mandate of the Ontario Municipal Board and the unveiling of the Province’s award-winning *Places to Grow* plan, which lays out a framework for future development



in the Greater Golden Ho2rseshoe over the next 25 years. Creating urban growth centres, raising densities and protecting rural areas are all featured prominently in the plan, while municipalities will be required to lay down plans that are consistent with the broad framework.

It remains too soon to tell how effectively the plan’s goals will be met. Public resistance to intensification is a real risk in the 905 region. In the City of Toronto, one of the key planning challenges will be to resist the ongoing temptation to convert scarce employment lands to residential, in view of the insatiable demand for condominiums in the downtown core.

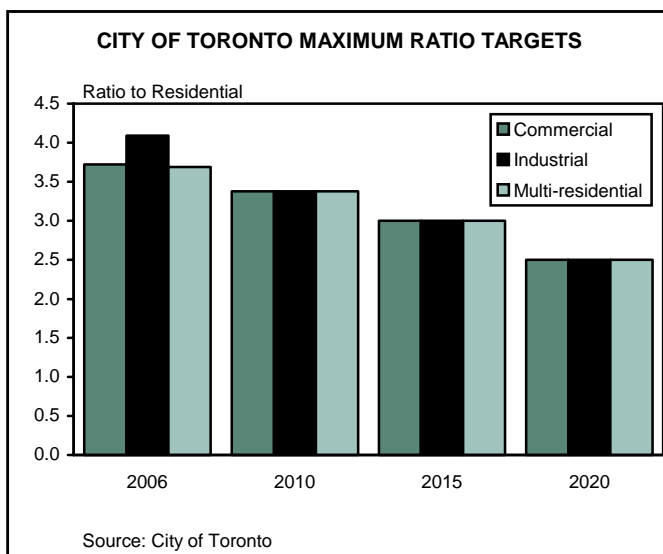
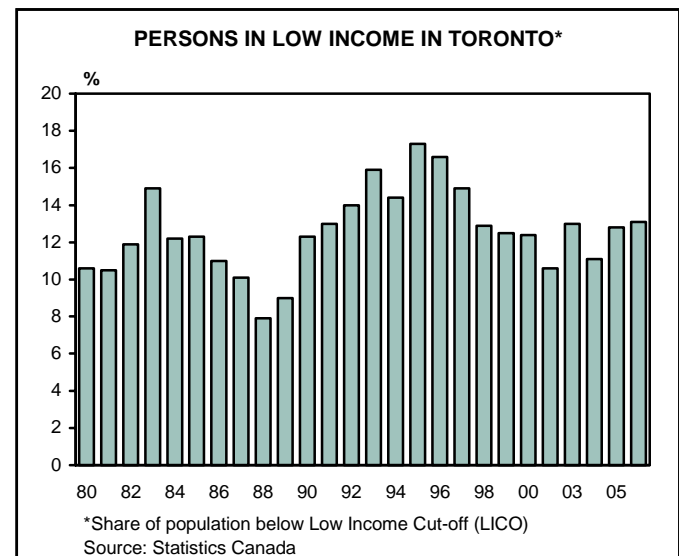
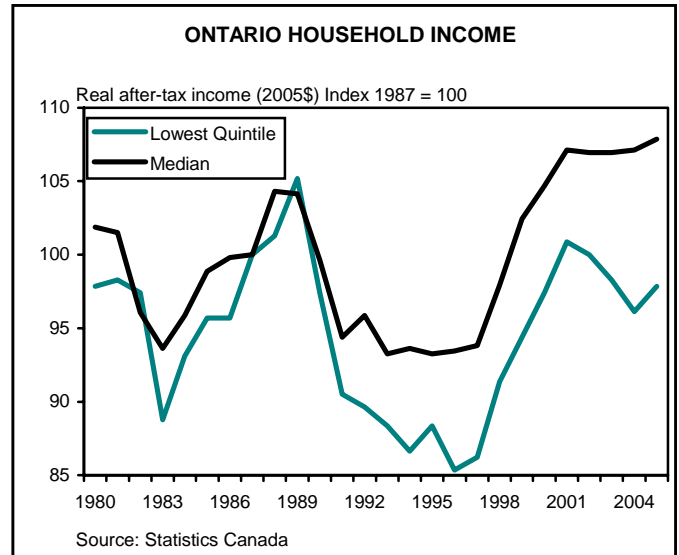
The City’s Waterfront is a good example of this difficult balancing act, as Waterfront Toronto (formally known

as Toronto Waterfront Revitalization Corporation) and the three levels of government work to transform the vision of creating vibrant, mixed-use space into reality. On a positive note, some benefits are finally beginning to flow from the revitalization process. In June, HtO – a design initiative featuring two new parks at Maple Leaf Quay East and West – was opened to considerable fanfare. In general, however, the pace of Waterfront development continues at a slow pace. Furthermore, some of the recent projects – notably the 2,000 unit condominium complex on 5 hectares at the foot of Yonge Street – have been raising concerns about whether the considerable opportunities for Waterfront development continue to be squandered.

(4) Social inequity and poverty worsening

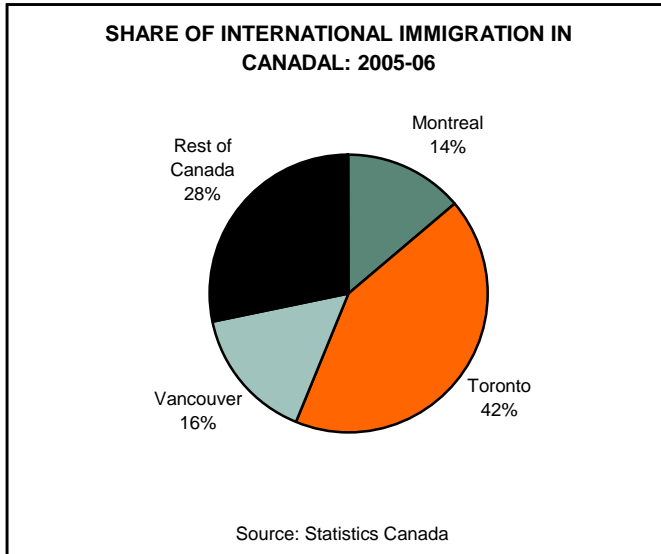
In 2002, we noted that, while the GTA economy had turned in healthy growth since the mid-1990s, many individuals were left behind. The 2006 Census data on incomes have not yet been released but, if provincial estimates are any indication, there has been no improvement in this area. In particular, the bottom 20% of families posted an outright decline in income between 2001 and 2005 – the only quintile to do so. Based on Statistics Canada’s low income cut-off, 13% of families in Ontario were deemed to be in low income, which is the same share as that which prevailed in 2002.

The aggregate figures conceal even more troubling trends below the surface. As highlighted in a joint report by the United Way of Greater Toronto and the Canadian Council on Social Development in 2004 entitled *Poverty by Postal Code*, the City of Toronto is standing out in the



GTA as recording an increasing number of higher-poverty neighbourhoods.¹⁰ The problem has also become more concentrated in the City’s inner suburbs – notably the former municipalities of North York, Etobicoke, York and East York – and within the immigrant population. Indeed, a January 2007 Statistics Canada report revealed that while newcomers to the country were better educated and more highly-skilled than their predecessors in the 1980s and 1990s, more of them are falling into poverty and staying there longer.

A particular challenge in confronting poverty in the City of Toronto is its self-perpetuating nature. The communities deeply affected by poverty tend to record high drop out rates at school and weaker academic performances.



Few of the people the poor are in regular contact with have links to opportunity. In the absence of this opportunity, there is a higher propensity to turn to violent crime. This dynamic poses a great risk to social cohesion in the region.

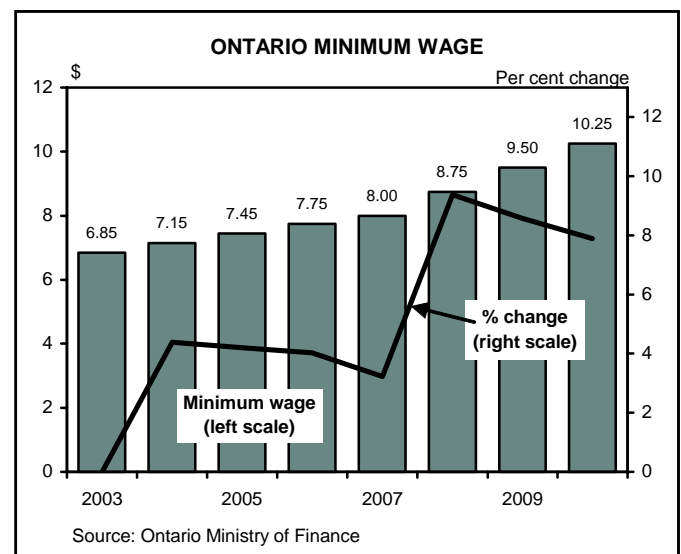
Toronto remains among the safest large cities in North America, but the increasing visibility of gun-related violence over the past five years has been attracting considerable attention. Recently, the Ontario government, which appointed a review committee to examine the problem of violence in Toronto, has led the charge calling for the federal government to ban handguns. Other voices have called for greater police presence in troubled communities, stricter sentencing and prompter deportation of criminals. These steps may be part of an answer. But they deal with some of the symptoms of a deeply-rooted problem that requires a holistic approach. The lack of job opportunities and poor community-school infrastructure in poorer neighbourhoods must be addressed. All three levels of government, community groups and the business community will need to step up to the plate.

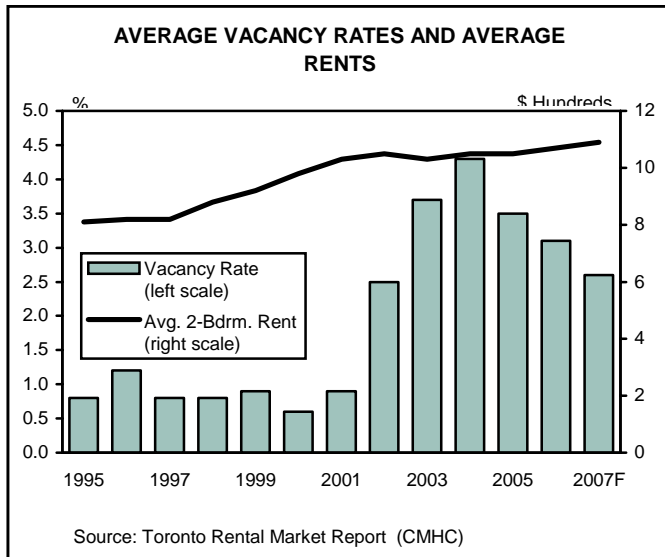
Encouragingly, there have been a number of new initiatives over the past years that have got the ball rolling. In 2004, the Strong Neighbourhood Task Force – which combined the forces of the United Way of Greater Toronto, the City of Toronto, the Toronto City Summit Alliance and numerous government, business and not-for-profit leaders – issued the report *A Call to Action*, which laid out a multi-pronged plan to address the systemic barriers to poverty in Toronto's hardest hit neighbourhoods.¹¹ The City has com-

plemented its involvement in the Task Force with the release of the Mayor's Community Safety Plan. That plan extends to areas such as crisis response, youth justice and youth opportunities, with a number of initiatives having been launched under each component. In 2006, the province spearheaded the creation of a Youth Challenge Fund (YCF), which works with community groups to identify youth at risk and fund programs that provide opportunity for these individuals. The goal of the fund is to raise \$45 million in public and private donations over three years. TD Bank Financial Group has supported the YCF in meeting this goal.

Community groups in Toronto have been innovative leaders in efforts to address poverty. Case in point is the "Pathways to Education" program that was developed in 2001 by the Regent Park Community Health Centre. The majority of the population in Regent Park is below the poverty line, four-fifths are visible minorities and 60% are immigrants. The focus of the program is to break the cycle of poverty by helping youth to stay in school through mentoring, financial support and other vehicles. The results speak for themselves:

- Since 2001, the average youth drop out rate in Regent Park has dropped from 56% to 10%. The comparable average for the Toronto District School Board is 26%.
- Increased college enrollment from 18% to 40% of graduates and university enrollment from 27% to 40%.
- Reduction in teen birth rate from 30 to 7.7 per 1,000 female students.





- This program has contributed to a decreased incidence of violent crime in the area.

Perhaps the best news of all is the long-term payback generated by the Pathways to Education Program. Boston Consulting Group (BCG) has conducted an analysis that looks at the net benefit to society from the program, which is the difference between gross benefits (i.e., lower government transfer payments and increased tax revenues resulting from higher education and labour force participation) and costs, both direct and in incremental provincial and municipal expenditures. Adjusted for time value of money, BCG estimated that the program is generating a net value of about \$50,000 per student, or equivalent to an internal rate of return of 9.4%.¹² The secret of Pathways' success has been the ability to harness the collective powers of funders, schools, the community and the Health Centre. Going forward, there are plans to expand the program, but to do so will require more formal and sustainable funding sources.

Meanwhile, the provincial and federal governments have also been nipping away at some of the fundamental barriers faced by working adults in low income. Prior to 2003, 75% of the earnings of Ontario's social assistance recipients above a certain minimal threshold were taxed back, creating a significant disincentive to work. This tax back rate has since been cut to 50%. Health benefits have also been extended for recipients leaving welfare for employment for six months. This year's budget season built on the momentum with the unveiling of a new Ontario Child Tax Credit and the Federal Working Income Tax Benefit, both of which were geared to low income families. Lastly,

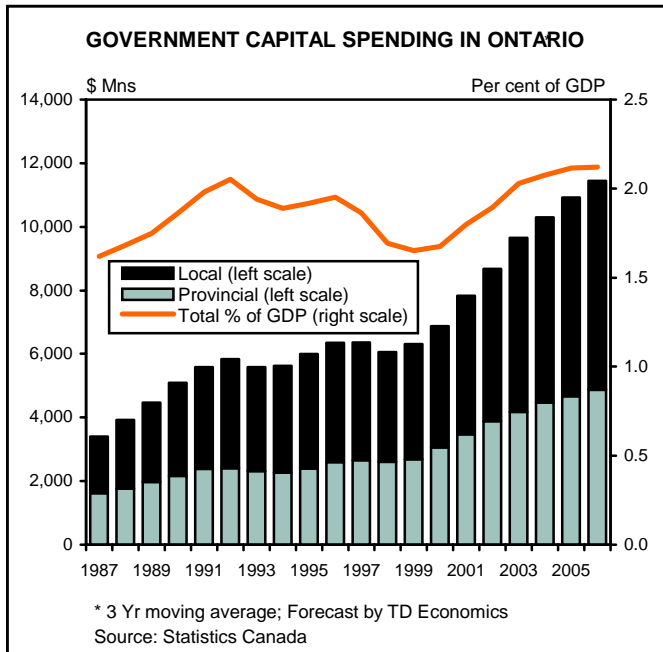
the Ontario government announced a further boost in the minimum wage – from \$8 to \$10.25 by 2010 – in its 2007 budget, despite the warnings by business groups that these hikes would negatively impact employment. Many of these recent initiatives are consistent with the recommendations outlined in a 2006 report by the Task Force on Modernizing Income Security for Working Age Adults (MISSWA), a group chaired by the Toronto City Summit Alliance and St. Christopher House.

We also highlighted affordable housing as a growing problem in the GTA. In May 2002, the average apartment rental vacancy rate was running at about 1% and there was upward pressure on rents. Since then, conditions in the rental market have eased substantially, with the average vacancy rate hovering at around 4% in April 2007. But, as we argued in the 2003 report *Affordable Housing in Canada: In Search of a New Paradigm*, "average" rents don't provide much insight on the supply of homes that are affordable to low-income families. Indeed, the flight of renters that have been lured into home-ownership in recent years has probably had the greatest impact on the rental-unit supply at the middle and upper ends of the rent spectrum. In any event, a good part of the recent increase in the vacancy rate is cyclical in nature.

Governments in the region have moved forward on a number of new programs that take aim at alleviating the affordable housing problem. Supported by \$392 million from the federal Affordable Housing and Off-Reserve Aboriginal Trusts, the Ontario government has launched three new housing initiatives to assist low-income families. Under the five-year housing allowance program, \$185 million was earmarked toward the provision of 27,000 new housing allowances, bringing the total to 35,000, and \$127 million was flowed to municipalities for investment in new affordable housing or to rehabilitate the existing stock. Another \$80 million was allocated to the development of 1,100 off-reserve housing units for aboriginal families. Lastly, under the Affordable Housing Program, the provincial government, in partnership with municipalities and the federal government, has set out to create 15,000 new affordable housing units and 5,000 housing allowances by 2011-12. To date, 7,400 housing units have been approved and 4,500 housing allowances provided.

(5) Erosion of infrastructure

In 2002, there were clarion calls for re-investment in the GTA's ageing transit, water and sewer systems, and



buildings and roads. Years of rapid economic and population growth had taken a toll on the region's physical foundation, with some water and sewage systems reaching a century in age. The sheer extent of the challenge was highlighted by various estimates of infrastructure spending needs. Probably the most cited statistic was that of IBI Group, which estimated that, if recent GTA development patterns continued, \$55 billion in new infrastructure capital plus an additional \$14 billion in operating costs (in 1990 dollars) would be required over the next 25 years. Just after the 2002 study was released, the Ontario government pegged total infrastructure needs of the Province at \$100 billion.

Governments at all levels in the region have stepped up with significant new funding for capital projects since 2002. In Ontario as a whole, total government fixed investment has rebounded from a low of 1.5% of GDP in the late 1990s to 2.2% over the past few years. This amount of support is well short of what is required to eliminate the backlog of projects, but it appears to have at least stemmed the upward trend in the infrastructure gap.

Infrastructure is one area in particular where governments in the region have marched to the same beat over the past few years – no doubt a reflection of the groundswell of public concern over the problem:

- The federal government has maintained infrastructure as a priority in its first two budgets. In total, \$33 billion has been earmarked towards infrastructure projects over

the next seven years, including significant amounts for border infrastructure and a 4-year extension of the annual gasoline tax transfer to municipal governments, which will ramp up to \$2 billion by 2010-11. In order to assist municipalities in their challenges, the federal government also raised the GST exemption on municipal purchases from 57% to 100%.

- The federal government has complemented the new funding with improvements to the way it delivers funding under infrastructure programs. For example, federal requirements on funding to municipalities under the gasoline tax are now subject to less-stringent criteria with less interference in local operational issues.
- The Ontario government has developed a 5-year \$30 billion plan aimed at addressing many of the Province's infrastructure needs in health, education, electricity, border crossings and transportation, among other areas.
- The provincial funding pie includes 2 cents per litre from the provincial gasoline tax to assist municipalities in capital funding for public transit projects – a promise worth about \$200 million per year. In contrast to the federal plan, which doles out funding on a per-capita basis, the provincial formula is based in part on transit ridership.

Above all, in response to growing congestion in the GTA, strengthening of the region's transit system has moved to the forefront. The Ontario and federal governments have each committed to covering two-thirds of the cost (one-third each) of a major capital expansion plan by the Toronto Transit Commission. And, in the most significant move yet, the Province announced a \$17.5 billion plan in June that would encompass 52 rapid transit projects in the GTA over the next 12 years. Two thirds of the cost (\$11.5 billion) would come from existing provincial revenue streams, while the Province will be looking to the federal government to fund at least 35%, or \$6 billion, of the cost of construction.

Overseeing the new provincial transit plan will be the newly-established Greater Toronto Transportation Authority (GTTA). The GTTA, whose board consists of mayors and council members across the region, was created by the Province in its 2006 budget to provide leadership in the planning, coordinating, financing and developing of seamless transportation network in the GTA and Westworth. Ultimately, the Authority will be responsible for the crea-

tion of a Fare Card system and taking on the future management of Go Transit.

The funding that is being directed toward transit and overall infrastructure improvements is a welcome development in the GTA. But notwithstanding the new injections, we've observed significantly slower progress in honing more innovative ways of delivering infrastructure, which we have argued is critical to boosting efficiency within the system and placing infrastructure on a sustainable footing (see TD Economics 2004 report, *Mind the Gap* and the 2006 report, *Creating the Winning Conditions for Public-Private-Partnerships in Canada*). Here, we're referring to making greater use of user-pay and P3s in funding capital projects. We have also argued that the fiscal and administrative shackles would need to be loosened on municipalities, since more than half of total public infrastructure requirements are directly within their purview.

Although the user-pay approach is being more widely applied in some areas – notably in water infrastructure, electricity and, most recently, garbage collection – there remains an overall reluctance to take advantage of marginal-cost pricing for infrastructure and other services. Between 2000 and 2005, the share of user fees of total local government revenue in Ontario remained unchanged and actually edged down at the provincial level. With advances in technologies, road tolls are increasingly being used around the world to address congestion problems and to achieve better environmental outcomes. Montreal is the latest city to raise the prospect of a congestion charge in its downtown. Yet there has been little appetite in the GTA for user-pay in the provision of transportation infrastructure. That said, Mayor Miller has recently shown more openness to the application of road tolls if they are implemented on a region-wide basis.

Over the past five years, there has been increased momentum towards the use of public-private-partnerships (P3s) in delivering infrastructure, particularly at the pro-

P3S VALUE FOR MONEY	
P3 COSTS	P3 BENEFITS
<ul style="list-style-type: none"> · Financing · Profit · Bid/Transactional Costs 	<ul style="list-style-type: none"> · Risk Transfer · Competition · Innovation · Asset maintenance and rehabilitation pre-defined prior to construction
Source: Yukon Economic Development, Overview of Public-Private Partnerships	

vincial and federal level. The province has established Infrastructure Ontario as a centre of expertise on alternative financing and procurement (AFP) – a moniker for P3s. The government has forged ahead with more than 40 projects, largely in the area of health care. As a good first step, the 2007 federal budget announced the creation of a P3 office and confirmed that it would be exploring a potential P3 to build and operate the planned Detroit-Windsor Bridge. In contrast, momentum behind these types of arrangements has not grown to the same extent at the municipal level in the GTA, and even less so in the City of Toronto.

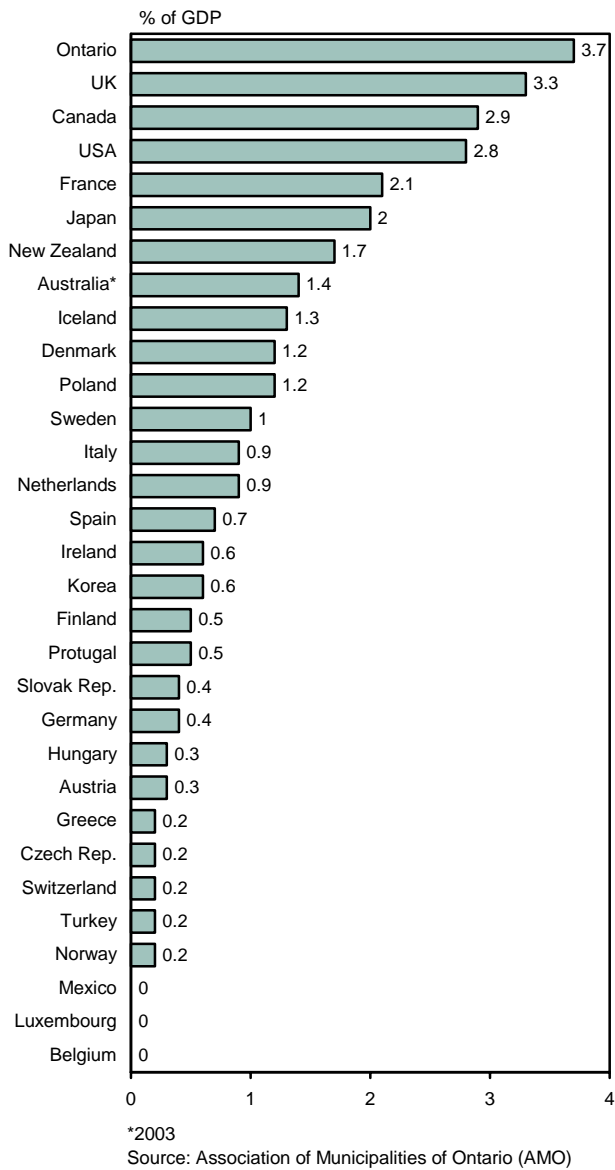
There's little doubt that governments in general continue to battle against some of the old hang-ups about P3s, notably public concern about private-sector involvement and a higher cost of private financing. As we discuss in a 2006 report, *Creating the Winning Conditions for P3s in Canada*, many of these issues are not well understood. As international experience shows, the secret to a successful P3 program boils down to the strength of the model. And as noted, the province appears to be touching many of the bases that have proved successful in other jurisdictions around the world. Federal leadership in building a pan-Canadian market for P3s would also be a plus.

(6) Loosen shackles on municipal governments

The final element in the 2002 report that was deemed

TRADITIONAL PROCUREMENT VERSUS P3		
TRADITIONAL PROCUREMENT	TO	P3 PROCUREMENT
Less competition and innovation	→	More private sector involvement
Government bears most risks	→	Risk is shared with the private sector
Public borrowing for new assets	→	More private capital
Taxpayers purchase assets	→	Taxpayers purchase a bundle of services
Inefficient procurement	→	On-time delivery of assets
Government responsible for the public interest	→	Government responsible for the public interest
Source: Yukon Economic Development, Overview of Public-Private Partnerships		

PROPERTY TAXES AS A SHARE OF GDP - 2004

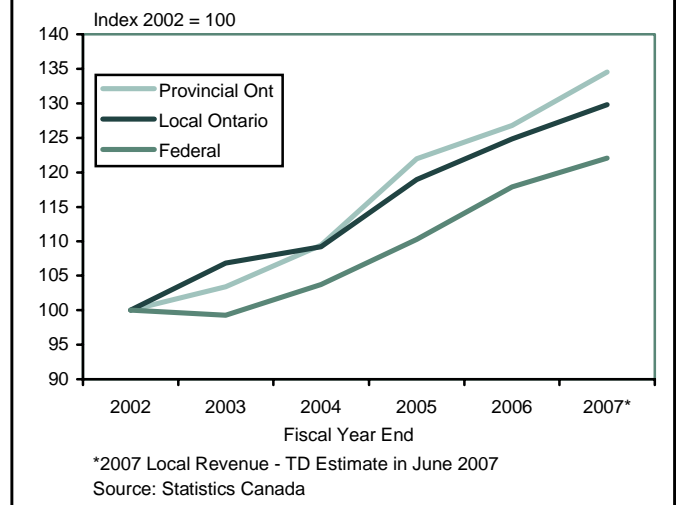


to be necessary to strengthening infrastructure and overall quality of life in the GTA was providing municipalities with more fiscal and administrative tools. This issue was found to be particularly pressing in light of the urbanization trends taking shape, the offloading of services by federal/provincial governments to municipalities in the 1990s and the competitive pressures emerging from the U.S., where aggressive actions were being taken to rejuvenate urban cores. Moreover, we argued that among GTA's municipalities, the City of Toronto was facing the most difficult predicament given the relatively slow growth of its tax base, an older

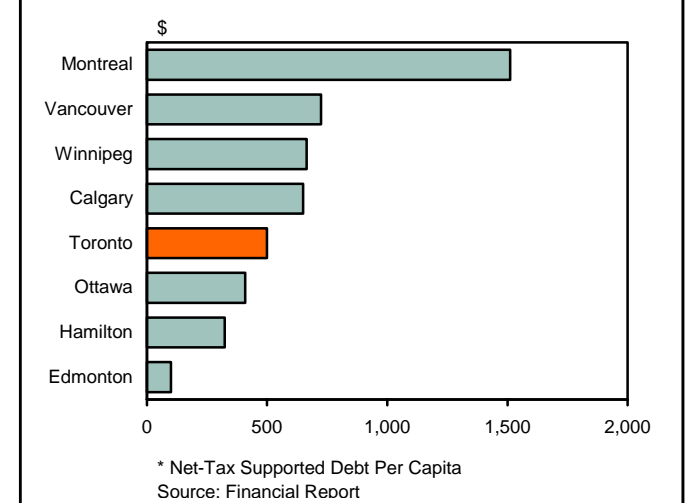
infrastructure, and heightened challenges in areas such as poverty.

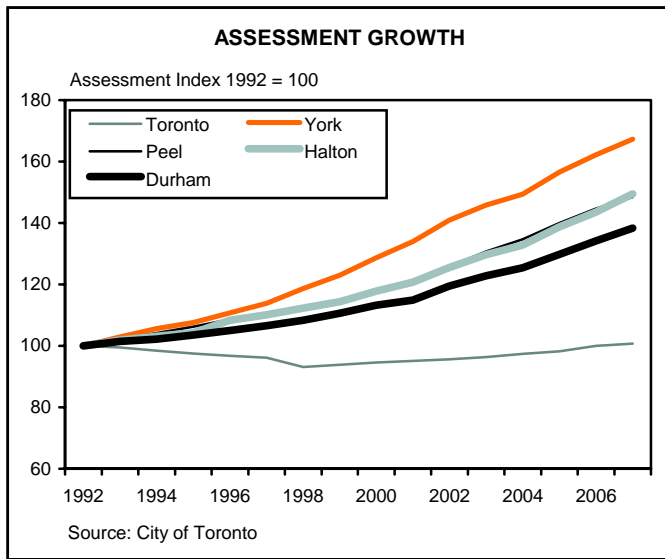
In addition to the increased funding provided to municipalities through provincial and federal revenue-sharing and grants programs, revisions made to the Ontario Municipal Act and the creation of a new City of Toronto Act by the Province marked a step forward in loosening the shackles. In short, as of January 1, 2007, Ontario's municipalities were provided with more flexibility to manage their affairs. And recognizing the City of Toronto's unique needs, the new City of Toronto Act has received extended powers in the areas of governance and finance. This includes the ability to enter into agreements with the federal government, establish council committees and to levy taxes in areas that aren't prohibited (i.e., taxes on income, general

GOVERNMENT REVENUES



NET DEBT* OF LARGE CANADIAN CITIES





sales and wealth are off bounds). Furthermore, the City of Toronto can now undertake tax increment financing (TIFs) – a U.S.-style instrument that we discussed in the 2004 *Mind the Gap* report. In particular, under a community improvement plan, the City has the ability to use TIF tools if they involve the municipal property tax stream, although in order to access the provincial education tax increment, approval is still required by the Province. The York subway extension and the Donlands are two TIF projects under consideration in the GTA.

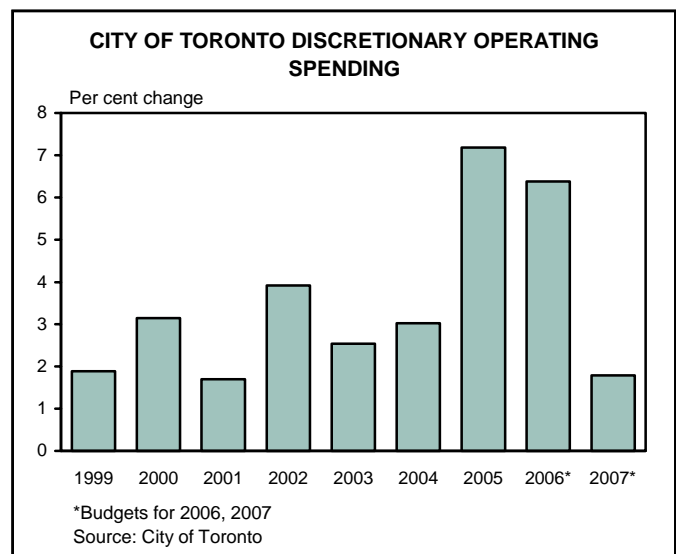
City of Toronto finances a regional risk

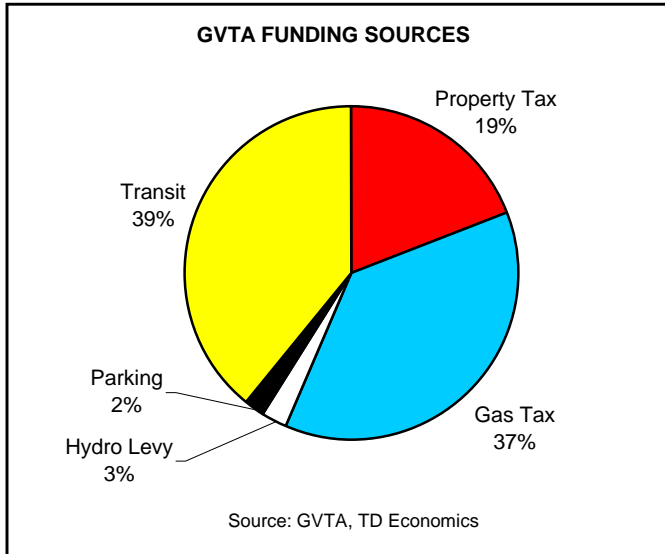
Despite running a year-end operating surplus of \$142.6 million in 2006, the City of Toronto's weak underlying fiscal predicament has deteriorated in recent years. Case in point is the 2007 budget, which featured another large drawdown in discretionary reserves and further tax increases of 3.8% on residential properties and 1.3% on business properties. Even with these measures, the City still recorded a budget shortfall of \$70 million. External groups have estimated the City's structural deficit (or shortfall that excludes one-time measures and the impact of short-term economic swings) at \$700 million to \$1.1 billion, with the latter figure amounting to 12% of the operating budget. And while the City of Toronto presently records a debt load that is in the middle of the pack among GTA municipalities, "status quo" projections released in its Annual Report show the debt burden climbing substantially over the medium term. This deteriorating financial position poses a risk to the overall GTA economy, given the region's close integration.

New taxes bring attention to City finances

Faced with its budget shortfall and armed with its new powers under the Act, the City of Toronto has wasted little time in putting new tax proposals on the table. Since the start of the year, a total of 8 new taxes have been under consideration, which we list in the text box on page 25. In recent weeks, the Executive Committee has recommended that two taxes be approved effective January 2008: a land transfer tax (LTT) of 0.5-2% of assessed property value, with an exemption provided for first-time buyers, and a personal vehicle tax of \$60 per vehicle. On July 16, 2007, City Council voted by a narrow margin to delay the decision on these taxes until its meeting in late October. Among the remaining taxes, the sales tax on alcohol (in stores only and excluding licensed establishments) and billboard tax were recommended for further study, while road pricing taxes (i.e., tolls) would only be considered on a GTA-wide basis, perhaps under the auspices of the GTTA. The other taxes were rejected outright.

If anything, the new taxes have helped to focus public attention in the GTA on City of Toronto finances and, in particular, the seriousness of the municipality's fiscal woes. It is not often that municipal budgets and fiscal developments receive the same public scrutiny as those of their federal and provincial counterparts. In the coming months, the spotlight will remain fixed on City of Toronto's fiscal developments. For one, debate will continue to rage about the new taxes themselves, with advocates pointing to the necessity of protecting existing services while critics arguing that the new levies, and in particular the land trans-





fer tax, will impose harm to the City’s competitiveness and contribute to urban sprawl. But, more importantly, even if the new taxes are approved in October, the \$360 million per year that would be raised would lower but not eliminate the City’s structural deficit. In our view, a move to decisively and effectively address this shortfall is critical to the GTA’s longer-term economic fortunes.

In confronting the fiscal challenge, there are four necessary steps along the path: (1) secure efficiency savings; (2) shift some of the cost burden to the provincial government in areas where it makes sense; (3) raise revenues efficiently; and (4) raise revenues just for the sake of raising revenues. Clearly, we would hope that the fourth option be used only as a last resort. We now run through these steps in more detail.

Step 1: efficiency savings

In recent budgets, the City of Toronto has taken some action to reallocate spending from areas of lower priority to those of higher priority. Toronto’s 2007 budget identified \$124 million in savings and efficiency gains or 1.6% of budget, which amounts to double that of previous years. But while the City has begun the process, spending reviews have yet to be extended to the full range of programs. Nor have agencies, boards and commissions been included, indicating that the machinery currently in place could be significantly strengthened.

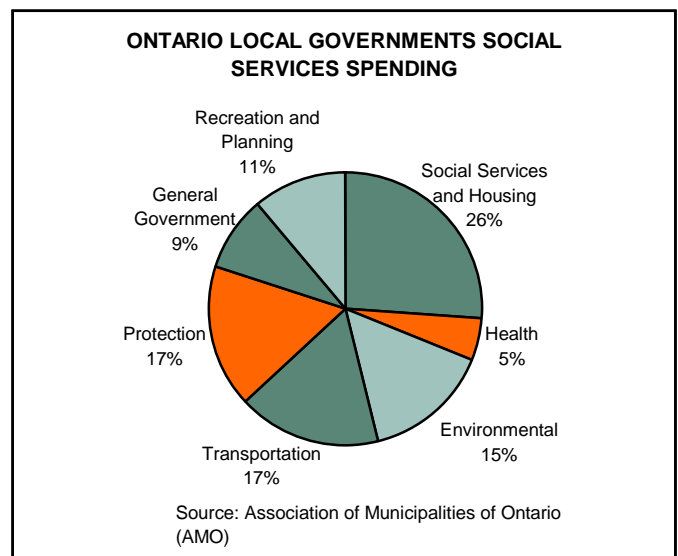
What’s more, compared to many of its counterparts in the 905, the City has been slow to embrace innovative approaches to service delivery and financing. In particular, public-private-partnerships (P3s) are gaining a toe-hold in

many municipal jurisdictions across Canada. Yet Toronto has shown a reluctance to move down this path. The City has pointed to some examples of cooperative ventures with the private sector and others involving innovative financing. But while opportunities exist across the gamut of public service areas, the developments undertaken have largely been confined to sports facilities (i.e., BMO soccer stadium, the Ricoh arena and the Lakeshore Lions arena project) and have involved the City, rather than the private sector, taking on the risk. Better leveraging the expertise of the private sector in areas that pass the litmus test of providing value for money to taxpayers would significantly enhance budget flexibility.

GTTA could set the stage for enhanced cooperation

Another area of opportunity and potential savings for the City of Toronto – and the rest of the GTA – is improved regional cooperation in the delivery of services. Some cities within the GTA have joined forces to accomplish certain goals. For instance, York and Durham Regions have been evaluating the possibility of a joint waste processing plant (although York’s recent decision to reduce the scale of its commitment in the project generated headlines). But, apart from some isolated examples, there is not only relatively little collaboration among the region’s municipalities, but there are fears that they may be becoming more insular.

The recent creation of the GTTA could be a turning point in terms of increased regional cooperation. However, until the GTTA develops a sustainable financial plan – which is expected later this year – the strength of its mandate



New Revenue Tools Open to the City of Toronto

- Land Transfer Tax
- Tax on Vehicle Ownership
- Sales Tax on Alcohol
- Billboard Tax
- Sales Tax on Tobacco
- Sales Tax on Amusement Activities
- Parking Tax
- Road Pricing

and its fiscal resources will remain uncertain. There are concerns that the GTTA will lack the appropriate regional support to make a real difference. Players in the GTA could take a page out of the playbook of B.C.'s Lower Mainland, which formed the Greater Vancouver Transportation Authority (GVTA) or Translink. The GVTA, which consists of a partnership of 21 municipalities, has been an effective model for regional transportation in the Vancouver Area only because it received the tools and the support of municipalities in the region. And among its various revenue-raising tools is a gasoline excise tax, which can be an effective tool in battling pollution and congestion within the commuter area.

Step 2: remove social services off the property tax base

Efforts to reallocate spending and improve program design should be a high priority. However, it is probably not feasible (or desirable) to eliminate the structural shortfall on the back of efficiency savings alone, especially when it's considered that about half of the City's net operating budget is earmarked to areas that would be deemed by many to be off limits: the TTC, police, fire and EMS (ambulance). Moreover, while average annual discretionary operating expenditures in the municipality have grown at a healthy rate of 4.5% per year since 2002, the pace has been more moderate than the 5-6% trend rate recorded in Canada's overall government sector.

That said, there is an opportunity to both relieve spending pressures at City and other Ontario municipalities and to pursue an avenue that makes economic sense. In the mid-1990s, social services and housing costs were downloaded to municipalities in the province. In the 2002

report, we made the case that it was more efficient to fund these costs through the income tax base given the fact that costs are driven by income fluctuations and disparities. Since then, while the Province has taken back costs for ambulance services, the responsibilities that remain have been a primary source of upward cost pressure in the City's budget in recent years. If fully implemented, the uploaded social costs could remove up to \$500 million from Toronto's operating budget and more than \$2 billion for municipalities in the province as a whole. And, significant hopes remain that some form of uploading will occur. The Ontario government has commissioned a Provincial-Municipal Fiscal and Service Delivery Review. The mandate of the Review is to recommend ways to improve the existing provincial-municipal arrangement by the spring of 2008.

About \$200 million in provincial uploading of social services responsibility from the City of Toronto is in fact already on the horizon, albeit with no net fiscal benefit to the City. In its 2007 budget, the Ontario government announced that it will phase out "pooling" in the GTA, which is the practice whereby municipalities with relatively low social costs, such as those in the 905 region, assist the City of Toronto in paying a share of its relatively high burden. As the transfers are phased out, the Province will take on responsibility for the social assistance and social housing costs funded under the program.

Step 3: raise revenues efficiently

A combination of efficiency savings and uploading of social service costs would be a major step forward in eliminating the City's structural deficit. Nevertheless, if those options fall short in closing the gap then the City may have to turn to revenue-raising measures.

It has been argued by some observers that the City of Toronto should first look to its residential property tax base as a means of raising revenues, since the City enjoys lower rates than surrounding municipalities. Lifting residential property tax rates to the average of the 905 region would yield an additional \$600-\$700 million annually. Such an approach can also be defended on the basis that it would accelerate the City's current long-term plan to create a fairer distribution across residential and non-residential tax burdens.

But, while this last point has validity, we have supported moves by the provincial government to grant municipalities with new taxes that grow more in line with the cost of service delivery, facilitate diversification away from the

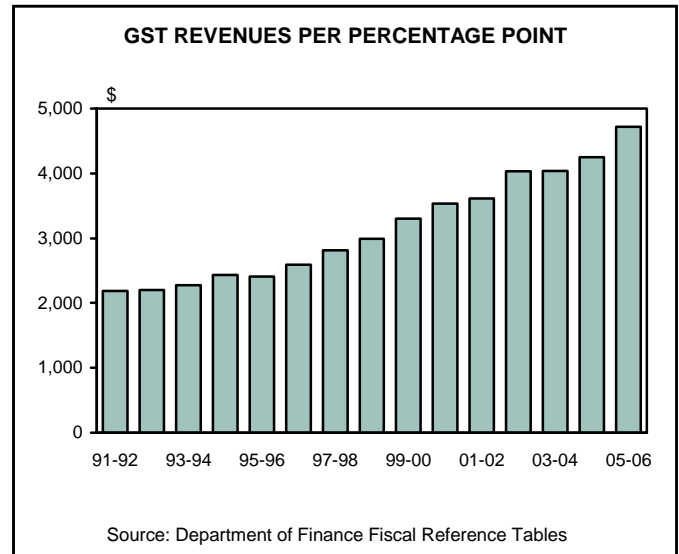
property levies and help to place local government finances on a more sustainable footing. New powers to tax – as opposed to receiving a federal or provincial grant or revenues transferred from a federal or provincial base – would also enhance accountability within the system. This is because when governments spend tax dollars collected by provincial and federal governments, they do not face the same pressure to ensure the money is spent efficiently than they would if they were levying the taxes directly. Accordingly, we viewed the powers provided in the City of Toronto Act in a positive light.

At the same time, however, we have also made the case that not all taxes are created equally. If the City is put into a position of having to raise revenues, we would prefer that the taxes be chosen on the grounds of efficiency and in their potential to achieve other goals simultaneously, including improved social and environmental outcomes. For example, one major advantage of using a road pricing strategy – complemented by significant investment in new transit capacity – is that it is an efficient way to lower congestion and reduce pollution. Although not on the list of new City of Toronto options, the same argument could be made for a gasoline excise tax. As has been demonstrated in B.C.'s Lower Mainland, such a tax could be levied and managed on a regional level by the GTTA with a clear link to transportation.

There are other considerations when mulling over revenue options. While sales taxes on alcohol and tobacco can be used to achieve positive social aims, they are more portable commodities and can be vulnerable to the border problem (i.e., an incentive for consumers to drive across the border to avoid the tax). In general, the City will need to be mindful of the fact that surrounding jurisdictions – which already enjoy a competitive cost advantage – do not have access to the same levies. Furthermore, there is the issue of cost of administering the new tax. To the extent that the tax can piggyback off an existing provincial levy and be collected by the provincial government, costs can be reduced.

Garbage levy a good step forward

While the proposed land transfer tax falls short on several counts – notably, it is not the most efficient and has little potential for spurring positive behavioural change – the Council's recent decision to charge residents for garbage collection represents a step in the right direction. As



of 2008, residents will choose from four different garbage bins and a wheeled cart, with the fee rising in tandem with the size selected. The plan, which will remove the cost of garbage collection off the property tax base, is expected to generate additional net revenues to the City of \$40-\$50 million that will be used to achieve other goals. One of those objectives is to earmark additional funds to expanded recycling and composting programs – notably to apartment buildings – and to help boost the City's garbage diversion rate from landfill from just over 40% to 70% by 2010. Compared to a simple "tag" system, the bin approach may be more cumbersome and could impede progress in reducing garbage disposal. Nonetheless, the shift to a user-pay approach in this area builds on the recent progress in funding water infrastructure and is a good step forward.

1 cent of the GST

There is little debate among economists that taxes on consumption are among the most efficient means of raising revenues. And, indeed, Toronto's Mayor Miller, along with the Federation of Canadian Municipalities (FCM) have been looking to the federal government to provide municipalities with a grant equivalent to 1 percentage point of the GST as part of a "National Transit Strategy". It is probably no coincidence that the timing of such a request lines up with the federal government's plan to shave a further percentage point from the GST in 2011. Mayor Miller and his counterparts are hopeful that Canadians will see the benefit of investing more than \$5 billion in local transit infrastructure (about \$1 billion to GTA cities and \$400 million to the City alone) compared to a savings in the form of

lower consumption taxes.

The federal government has rejected the cities' request outright. Still, if this were a route taken, we would prefer that the cut in the GST be accompanied by providing the authority to municipalities to levy their own sales tax of 1%, in order to pass the test of accountability. This approach could also be carried out concurrently with a provincial-federal move to harmonize the GST and PST. A strike against the providing cities with the freedom to levy a local sales tax is that, similar to the alcohol or tobacco excise taxes, it would run into the border problem.

Step 4: Raise revenues just to raise revenues

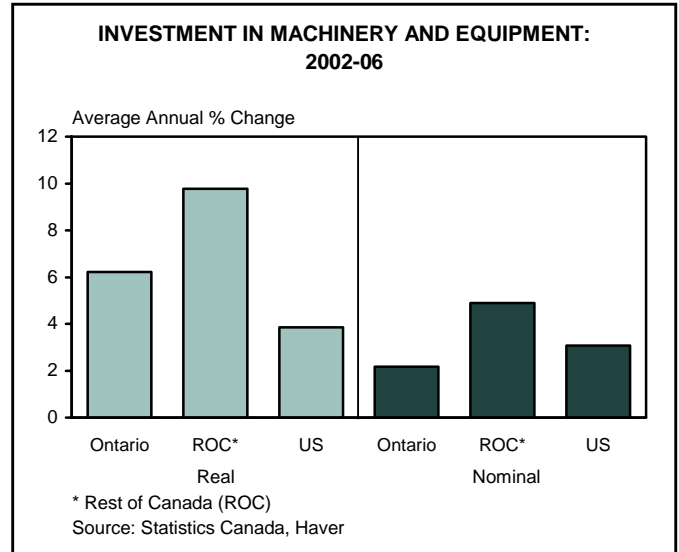
The City of Toronto and other players in the GTA must take a keen interest in ensuring that the first three options be applied in order that the fourth alternative – relying on inefficient taxes purely to plug the budget hole – be avoided. Raising revenues just for the sole purpose of raising revenues would mark a missed opportunity for the region as it works to enhance its economic sustainability.

Leadership required

Exploring all the avenues, avoiding “quick fixes” and focusing on well-thought-out policies is no easy task. Hence, there will be a need for strong leadership. We urge the City of Toronto to lead the way within the region in the thinking outside the conventional fiscal box in government service delivery and innovative new financing techniques. On the plus side, the City has been demonstrating leadership in the environment, with recent initiatives in fighting global warming receiving accolades at the recent C-40 meeting of large global cities. We look for this strength to be extended to other areas.

Increased civic involvement of private sector critical

Efforts to strengthen the GTA will run into a roadblock without increased participation from the private sector. Many of the region's large businesses depend on the GTA region for both its hiring pool and sales. Thus the private sector has a vested interest in ensuring that the GTA locomotive remains firmly on the rails. The bulk of this *Update* has focused on government responses over the past five years to the region's challenges, since the public sector sets the ground rules to which the private sector responds. There is a good case to be made, however, that, despite some of the recent developments and the progress made on the policy front, the private sector has fallen short.



Consider the surge in the Canadian dollar. One of the benefits of a stronger loonie is that it lowers the cost of machinery and equipment (M&E) imports from the United States. Yet total business spending on M&E in Ontario rose by just over 2% per year in 2002-06, considerably lower than both the growth rates of corporate profits (7%) and the overall economy (4%). Even in real (price-adjusted) terms, growth in M&E outlays was a surprisingly lacklustre 6.2%, well below the 10% registered in Canada as a whole. In addition to the strong currency, manufacturers should take advantage of the two-year write-off for M&E purchases that was announced in this year's federal budget. Without incorporating technology into the production process, the GTA will be hard-pressed to make up growth on the labour productivity front.

In general, the private sector will need to become more aggressive in taking advantage of growth opportunities as they arise. For example, China is providing tremendous possibilities for business expansion. But many companies in the GTA have yet to devise a China strategy. Activities in research and development, venture capital, designing innovative training for employees need to be ramped up. And while much of the weight of success in public-private-partnerships is put on the quality of the model that is adopted by governments, the business sector has a major role in ensuring that these arrangements generate value to taxpayers.

In the 2002 GTA report, we highlighted the fact that business involvement in civic matters was crucial to the success of a city region. Happily, over the past five years, many private sector players have made tremendous in-

roads on this front. In particular, the Toronto City Summit Alliance (TCSA) – with over 2,000 volunteers across business, non-profit, government and labour – has been a considerable force in bringing the public and private sectors together to spur positive change. Earlier this year, the TCSA convened its third City Summit, *Making Things Happen*, hosting 630 leaders from the business, labour and non-profit sectors. Since 2003, the Alliance has set up organizations and issued numerous reports that aim to tackle many of the region's greatest vulnerabilities. The TCSA is generating a strong momentum that other private-sector players can build on.

Bottom Line

Despite positive actions by governments in a number of areas over the past half decade, a number of new threats to the region's future prosperity have emerged. Among

the various challenges, three stand out in our view. First, the rise the Canadian dollar, energy prices and international competition have eroded the region's competitiveness and raised serious questions about the viability of the GTA's all-important manufacturing sector. Second, the rising incidence of low income among the region's newcomers and the self-perpetuating cycles of poverty, which pose a threat to the cohesion of the region. And, third, the City of Toronto's structural deficit, which threatens to hold back the City from dealing with many of its own challenges and reduces flexibility to take on a leadership role within the region. Never before has there been a greater need for the region's players, including the public and private sectors and community groups to band together in a united effort.

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