Executive Summary

There has been a lot of attention paid to Ontario’s near-term economic fortunes, and especially the question of whether a recession is in the cards this year. But our greater concern surrounds the economy’s long-term path. Why is that? Ontario’s past success has been due to a thriving industrial base, which in turn, was largely built on a foundation of a competitive and often undervalued Canadian dollar, relatively free access to the U.S. market and low cost energy supplies. Yet a thesis of this report is that a cyclical rebound in the U.S. economy won’t be enough to restore this foundation. Much of it appears gone forever.

This is not to say that Ontario can’t prosper again. But the province will need to set its sights on a different kind of prosperity and exploit different advantages. Above all, a different policy backdrop will be required.

In this report, we frame the key questions about where the Ontario economy will be in 2020. Will it continue to wither? Or, will Ontario manage to regain the kind of dominant economic presence that bestowed abundant benefits to residents in past decades? Clearly, the objective has to be the latter. Even more importantly, what will it take to achieve such an objective? We believe that it will take bold policy action from the provincial government in concert with other governments and the private sector in nine key areas:

- Top quality labour force
- Effective integration of immigrants into the workforce
- World class infrastructure, including transit
- Reliable electricity system
- A leader in the environment
- Competitive tax system
- Enhanced trade
- Shift from dependence (welfare) to labour force participation
- Supportive federal policy

As we discuss on pages 9-19, parts of the puzzle have already been put into place. But other parts need to be added and the pieces must fit together.

**Wanted: a broad discussion paper this fall …**

We recommend that the Ontario government put out a broad discussion paper this fall on where it wants to take the economy over time. Such a report, which would replace the relatively sterile exercise of the mandated long-term economic and fiscal outlook, could form the basis of debate on the issue. It is vital that the discussion paper not just be about numbers and budget balances. It should address the fundamental issues that matter to Ontarians – jobs, income and making people’s lives better.

**…followed by action starting in the 2009 budget**

As importantly, the government must move swiftly to turn the vision into reality. An overnight shift to a desired state along the lines of the one we’ve defined above would be very expensive. Yet the Ontario government is likely to find itself with shrinking fiscal wiggle room over the next few years. In fact, based on TD Economics’ 5-year “status-quo” fiscal forecast, the provincial government is facing modest planning deficits (i.e., shortfalls after deducting the customary reserve allowance) over the next two years and small but growing surpluses beginning in fiscal 2010-11. The status-quo forecast builds in TD Economics’ projections and measures already committed to in past budgets and economic updates.

**Slowing economy no excuse for inaction**

The government can still make a significant downpayment on an economic vision, however. On pages 20-21, we touch on several ways that fiscal leeway can be augmented. One in particular is the elimination of the Ontario government’s annual contingency reserve, which typically amounts to about $1 billion. This recommendation is made with some reservation and is most definitely not an invitation to return to an era of fiscal recklessness. Rather,
it flows from a belief that policy measures – notably tax cuts targeted at improving Ontario’s competitiveness – would be a better use of resources at this time.

Furthermore, Ontario’s ability to strengthen its economic foundation would improve further if the federal government stepped up and addressed outstanding aspects of “discrimination” with the province. Put simply, any long-term Ontario vision is surely to fail without supportive federal policy. Yet the net federal fiscal take from Ontario amounts to a huge 4% of Ontario’s GDP. We call on the federal government to immediately move to per-capita block funding for health care and to promptly tackle Ontario’s legitimate beefs in other areas, including funding for infrastructure, worker training, and immigration settlement.

Together, these actions would enhance Ontario’s fiscal fiscal flexibility over the 5-year forecast horizon. Rather than edge up to a mere $1.4 billion by fiscal 2012-13, the province’s planning surplus would reach $5 billion, which would represent the amount that could be earmarked for new tax and spending measures without moving into a deficit. That said, $5 billion is still a finite amount that requires tough decisions on how it should be divvied up among the key policy areas.

**Tax cuts need to feature more prominently**

In our view, one thing is for sure. Tax reductions need to feature more prominently in the vision than they have in recent budgets. Since fiscal 2004-05, virtually all the $20-$25 billion in new resources was earmarked to new spending. In contrast, the sum of total tax cuts announced over the period was not enough to offset the revenue hike resulting from the introduction of the health-care premium tax in 2004. Going forward, a more effective division of resources would be 50:50. Based on our forecast, that would mean $2.5 billion annually in both tax cuts and spending increases by fiscal 2012-13.

In our view, new spending measures should encompass additional support for education and for municipalities through a further upload of social services. The focus on the tax side should be on addressing those areas most damaging to growth. And with the productivity-impeding capital tax set to be eliminated, the priority should become improving business and personal income-tax competitiveness. As well, we strongly urge the government to replace the provincial sales tax with a harmonized GST or a system such as that applied in Quebec. The negative hit on Ontario finances due to sales-tax reform could be partly offset by offered federal financial assistance for provinces that harmonize with the GST.

Still, $2.5 billion in resources would only allow the government to scratch the surface in terms of addressing these tax competitiveness challenges. For example, cutting the corporate income tax by 1 percentage point alone would absorb about one third of the room. There is an option, however. A key pillar of the vision we lay out is environmental leadership. Accordingly, the government could consider introducing a new revenue source, such as a carbon tax, that would clear the deck for significant reductions in higher-priority corporate and personal income taxes.

For illustrative purposes, the introduction of a B.C.-style carbon tax could enhance resources available for income and other tax cuts by a further $4 billion by fiscal 2012-13. That would leave enough room to cut the CIT rate from 14 to 10%, accelerate already-announced moves to reduce business education tax rates and eliminate the small business income-tax clawback. We figure that at least $1.5-$2 billion or about one-third of the total amount available for tax cuts could be used for personal income tax reductions. Admittedly, that is not a huge amount, given that a fulsome plan to address the province’s high personal marginal tax rates would run more in the order of $7-$10 billion. As such, the reductions should, at least initially, be earmarked towards lowering marginal personal income tax rates for low- and modest-income earners. Cutting the first tier of income-tax rates and further scaling back the tax-back rate of benefits on the additional income of welfare recipients are two areas deserving attention.

**The bottom line**

With much of Ontario’s economic success driven by advantages that no longer exist, a new direction is required. We look to the provincial government to take leadership on this front by developing a vision on where it plans to take the economy down the road. Some of the pieces have already been put in place. But as we discuss, other parts need to be added and all the pieces need to fit together.

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TIME FOR A VISION OF ONTARIO’S ECONOMY

Much of the Foundation of Past Economic Success Has Crumbled

The Ontario economy is currently in its biggest funk since the early 1990s downturn, partly reflecting the impact of U.S. economic difficulties and the ongoing global credit crisis. But while much of the attention has been cast on the province’s near-term fortunes – and especially the question of whether a recession is in the cards this year – our greater concern surrounds the economy’s long-term path. A thesis of this paper is that several underlying pillars of Ontario’s past economic success have toppled over the past 5-10 years in the face of a shifting global landscape. It is becoming apparent that a cyclical rebound in the U.S. economy won’t be enough to restore the foundation. Much of it appears gone forever.

This is not to say that Ontario can’t prosper again. But prosperity will have to be laid on a different kind of foundation. Different advantages will need to be exploited.

Above all, a different policy backdrop will be required.

In this report, we frame the key questions about where the Ontario economy will be in 2020. Will it continue to wither? Or, will Ontario manage to regain the kind of dominant economic presence that bestowed abundant benefits to residents in past decades? Clearly, the objective has to be the latter. Even more importantly, what will it take to achieve such an objective? We believe that it will take bold policy action from the provincial government in concert with other governments and the private sector. Parts of the puzzle have already been put into place. But other parts need to be added and the pieces must fit together.

This fall, we recommend that the provincial govern-
ment put out a broad discussion paper on where it wants to take the economy over time. Such a report, which would replace the relatively sterile exercise of the mandated long-term economic and fiscal outlook, could form the basis of debate on the issue. It would then be followed by action beginning with the 2009 spring budget. It is vital that the discussion paper not just be about numbers and budget balances. It should address the fundamental issues that matter to Ontarians – jobs, income and making people’s lives better.

Consider this report a contribution by TD Economics to the discussions. We envisage three parts to the overall approach. First, what needs to be in place before 2020 to have a prosperous Ontario economy? Second, what are the gaps from where we are now heading? And third, how do we close those gaps? The final part must address barriers to action.

All eyes focused on the short term

With virtually all factors conspiring against Ontario’s economy recently – chief among them slumping U.S. auto sales, declining American tourists, still-high Canadian dollar and commodity prices, slowing housing activity and a tapering off in growth in the financial services industry – the provincial economy recorded an outright decline in real GDP in the first quarter. And recent data have tipped the balance towards a second consecutive real GDP drop in the second quarter. Based on the simple two-quarter rule of thumb, Ontario may indeed already be in recession.

TD Economics weighed in on the question of a near-term recession in a July 2008 report (Are the Wheels Falling Off the Ontario Economy?) In sum, we argued that a proper definition of recession extends the assessment of economic performance to a broad array of indicators (GDP, employment, industrial production, retail spending, etcetera). And by that count, the definition had not been satisfied, although the test would come in the second half of 2008 and early 2009. Nevertheless, with the Canadian dollar and commodity prices having fallen off their peak and interest rates remaining low, our short-term forecast was more representative of an economy moving sideways than the deep-recession scenario that was suffered in Ontario in the early 1990s.

Even though a short-term economic crisis doesn’t appear to be at hand, the souring economic news heading into the autumn will put particular pressure on the Ontario government to take immediate action to revive the economy. As we argued in July, the truth of the matter is that there isn’t a whole lot that can be done about deteriorating economic prospects in the short term, except perhaps spurring construction activity by accelerating some infrastructure spending already on the books. On the other hand, if the economy is hit unexpectedly hard, or if revenues come under significant downward pressure, aggressive action should not be taken to reduce the impact on the budget balance. The automotive stabilizers should be allowed to operate. Most importantly, the Ontario government would best serve its residents by keeping its eyes focused on the longer ball, and in particular, addressing the onslaught of secular challenges that have arisen in the past 5-10 years and that won’t be erased by a cyclical recovery in the U.S. economy.
Ontario economy will never be the same

The need for a new economic vision resonates when it is considered how much the playing field has changed over the past 5-10 years. Ontario has enjoyed one of the world’s highest standards of living in good part due to a thriving industrial base, which in turn, was built on the following foundations:

- 1965 Canada-U.S. Auto Pact, which jump started an auto-based industry in Ontario;
- Relatively free access to the U.S. market, especially following the signing of NAFTA in 1994;
- Competitive and often under-valued Canadian dollar, which helped Canadian producers to penetrate U.S. markets by way of a significant cost advantage and protected domestic producers from U.S. competition;
- Low cost energy supplies, assisted by abundant global supplies of crude oil and other fossil fuels and government subsidized power prices;
- Lower health costs associated with Canada’s public health care system;
- Skilled labour force;
- Good location, with a consumer market of more than 120 million people within 1 day’s drive of southern Ontario.

With these tailwinds in place, the province enjoyed an unprecedented manufacturing export boom that has been paralleled by few jurisdictions around the globe. By 2000, real manufacturing output in Ontario had surged to a hefty 23% of real GDP. In that same year, Ontario shipped almost $3 to the United States for each $1 sent to other provinces. In 1980, the ratio was about 1:1. Many of the province’s large exporters heaped benefits on the economy by recording higher productivity and paying higher wages than average. What’s more, around this thriving sector popped up many related goods and services industries which provided further support to the province’s standard of living.

Since the end of the 1990s, this economic foundation has been badly shaken. In 1999, the Auto Pact was struck a death blow by the World Trade Organization (WTO). Two years later, access to the U.S. market experienced a major setback by the enhanced security measures implemented by the U.S. in the wake of the September 11th terrorist attacks. Subsequently, the United States has opted at each turn to put security interests ahead of commerce. Furthermore, Ontario-based companies have been faced with increasing low-cost competition from Asian producers both at home and within the U.S. market – a pressure that has intensified significantly following China’s entry into the WTO in 2001. As we discuss in the text box on the next page, another wave of pressure has been emerging from south of the border, where workers have been responding to global competition by accepting lower wages and benefits.

On the currency front, while the Canadian dollar is expected to lose some further ground over the medium term, few analysts are projecting a return to the sub-80 US cent level that provided Ontario producers with a significant cost
Will Ontario’s Wages Be Hollowed Out?

Even though overall job creation in Ontario has been strong since 2002, the province has witnessed the disappearance of abundant well-paying manufacturing jobs. The declines in manufacturing employment (in percentage terms) have been most significant in those lower-value-added industries where global competition has been more fierce, such as textiles, clothing and primary metals. But even in the bulk of higher-value-added manufacturing industries that pay more than $20/hour to hourly employees, net jobs have been in retreat over the past half decade.

In contrast to jobs, manufacturing wage rates have continued to rise at a moderate rate across the board. But wages may be the next shoe to drop. Look no further than the United States, where global competitive pressures have begun to spill over to wage and benefit structures. U.S. developments are important since Ontario’s manufacturing sector competes directly against its U.S. counterpart on productivity and costs per unit of labour.

Perhaps the best example is in the U.S. auto sector. When 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 about US$27 per hour, before the company fell into bankruptcy in 2005. In order to exit bankruptcy protection, workers voted in favour of company demands to chop wage rates to US$14-$19 per hour and to cut back benefits sharply. Other troubled U.S.-based parts suppliers (i.e., Dana and Dura) have been following suit by similarly moving to scale back compensation costs and outsourcing to lower-cost jurisdictions around the world, creating a new norm within the industry.

The push to lower wages and benefits has extended to the U.S. assembly sector. Last year’s UAW agreement with the Big 3 included a move to a two-tier wage system, which distinguishes between assembly workers (Tier 1) and non-assembly workers (Tier 2). New Tier 1 hires will be paid the same wages as existing workers, but on the benefits side, they will receive US$1 per hour in lieu of post-retirement health benefits – which will save auto makers over US$10 per hour. New Tier 2 hires will be brought in for US$14-16 per hour, reducing total labour cost for these workers from over US$70 per hour to about $26-31. In addition to bringing workers on at the lower wage, the automakers can reclassify a maximum of 20% of their existing employees to Tier 2.

The CAW has played down the threat from the UAW contracts. All-in labour costs of the Canadian operations of the Big 3 are about $77 per hour.1 Even under the new UAW contracts, the CAW has calculated that the break even point for labour costs with the U.S. operations occurs when the currency is at about 90 US cents. While the the cost disadvantage for Canada becomes 5-10%, this differential is currently offset by a 10% Canadian productivity advantage. Certainly, as the U.S. workforce moves to Tier 2 status over time, that will increasingly favour the U.S. cost picture. But under the CAW cost assumptions, this shift will be slowly implemented and other aspects of U.S. compensation package, such as health care costs, are poised to grow more rapidly than in Canada. Hence, the CAW believes Canadian relative cost competitiveness can be preserved without making major concessions.

This assumption of a slow phase in of Tier 2 workers may prove to be optimistic. The U.S. operations of Big 3 companies have been ramping up efforts to “buy-out” existing workers through generous packages in recent months, and reports are that the take-up rate has been high. Indeed, it has been estimated that within 10 years about four-fifths of the U.S. labour force of the Big 3 will consist of workers at the lower rate structure.

The risk of a “hollowing out” of abundant high manufacturing jobs with plentiful benefits in Ontario is not just an economic phenomenon, but also a socio-economic one. In the past, manufacturing workers – even those low-skilled – could achieve status at the middle or higher end of the income spectrum. This is likely to be harder in the future.
advantage. Ditto for energy prices, which had hovered in the ultra-low US$10-30 range in the 1990s and early 2000s but are now unlikely to fall below US$80 for a sustained period. And since the 2003 power blackout, which set off alarm bells about the province’s vulnerability with respect to electricity supplies, the provincial government has been weaning producers off subsidies. Indeed, with some 80% of existing generation capacity to go out of production over the next two decades, there are growing concerns among industrial users regarding the availability of supply at almost any price. In sum, with the exception of the skilled labour force, health care costs and location, these competitive strengths are probably gone forever. Furthermore, a case could be made that two of these three remaining advantages – skilled labour force and health care – may soon start to come under pressure from an aging population, a rising dependency ratio and soaring healthcare costs.

**Adjustments in manufacturing have been masked**

On the surface, the Ontario economy appears to be coming through this monumental transformation quite well. Manufacturing output has been reduced and job losses within the sector have mounted over the past few years. Yet until very recently – when the impact of the U.S. slowdown really began to bite – the provincial economy had been expanding at a moderate 2.5% annual rate. In fact, the average rate of real GDP growth in the 2002-07 period was roughly 2.5% per year, which is not far off its historical rate of 3%. Even more impressively, job growth was bang on the 30-year average of just under 2%.

There is more to the story than meets the eye. A combination of a booming Ontario housing market, a surge in public sector hiring and rapid expansion of financial services activity (which was partly attributable to a short-term explosion in securitization) have helped to mask weakness in manufacturing by generating demand for construction-related products and propping up overall economic growth. Meanwhile, U.S. consumption of autos and forest products produced in Ontario were artificially inflated earlier this decade by historically easy credit which is unlikely to
Ontario job creation has maintained a solid pace over the past half decade despite the downward pull on total employment from net reductions in the manufacturing sector. A closer look shows that some notable industries have been punching beyond their weight in order to take up the slack. While the construction sector accounts for only 6% of total Ontario employment, it comprised more than twice the share (14%) of the net new job gain since the end of 2001. Not far behind were public services (40% of net new jobs or 1.8 times its industry weighting), accommodation and food (11% and 1.7 times) and financial, insurance and real estate services (11% and 1.5 times).

More recent figures highlight a growing vulnerability within Ontario’s job market. Over the past year, construction employment has remained a major driver of job creation in the province. In fact, the 40,000 jobs created accounts for about three-quarters of the province’s 52,000 overall net gain. However, since April, the employment trend-line has flattened. The same holds true for both public services and financial services, with the former appearing to have peaked in the spring and the latter moving sideways since the global financial crisis broke out in August 2007. On the brighter side, accommodation and food has continued to add jobs in recent months.

Recent trends suggest that the powerful job-creation offsets from areas such as construction and public services have probably peaked for a while, shining the light more brightly on the ongoing bleeding in manufacturing jobs.

Ontario economy could continue to slip

Other broad measures of Ontario’s economic performance since 2000 have been more sobering. Based on work by the Ontario Institute for Competitiveness and Prosperity, Ontario has continued to lose ground against 14 competing U.S. states of similar size and Quebec. In 2003, the gap in real GDP per capita between the benchmark median was $5,100. By 2006, it had increased to $6,000. In level terms, Ontario prosperity sits second lowest among the 16 jurisdictions, above that of only Quebec.

Perhaps most striking has been Ontario’s dwindling position within the Canadian context, where higher commodity prices and booming resource revenues have been shifting the balance of income and economic power to the west. Since the start of the decade, Ontario has moved from above-average nominal GDP per capita to 2% below. And based on TD Economics’ estimates, the combination of the commodity boom and reforms made to the equalization formula is poised to make Ontario an equalization recipient by fiscal 2010-11 – and perhaps as early as next year.
Ontario’s foray into equalization payments could prove fleeting, especially if the economy turns in a strong economic recovery beyond 2010. However, these longer-term secular trends present growing risks to Ontario’s longer-term rate of expansion. Consider a simple illustration. Real GDP growth can be decomposed into two drivers: growth in the labour force and growth in labour productivity, or the success in turning labour inputs into output. Historically, both have run at a rate of around 1.5% per year, yielding a trend rate of real GDP growth of about 3% per year. However, both of these elements could come under significant downward pressure over the long haul. The gradual downward pull on labour force from an aging population is not unique to Ontario. But while an acceleration in productivity could help to offset this impact, this seems unlikely given the likelihood of a further gradual shift away from the province’s Ontario’s industrial base – which tends to have a higher value-added per worker – to areas of lower value-added. In fact, it could head lower, leaving trend growth in Ontario running at one-half to two-thirds its recent trend rate by 2020.

Where do we want to be in 2020?

In order to prevent further withering of the Ontario economy the province will need to set its sights on a different kind of prosperity and exploit different strengths. Real effort to drive innovation, research and knowledge, rewarding investment and embracing the environment will have to be front and centre. There will be a big place for a thriving automotive/manufacturing sector in the Ontario economy of tomorrow. But there needs to be a greater recognition that well-paying manufacturing jobs can only be sustained through increased productivity. Higher productivity will help all aspects of manufacturing but in particular should support the necessity of moving further up the value-added chain.

Inevitably, other high-value added sectors will need to pull more relative weight in contributing to incomes in the province. Here, it is important to think broadly about the potential economic power of developing leading sectors, such as financial services. The emergence of Ontario’s auto assembly sector following the implementation of the Auto Part brought parts and transportation services. In financial services, the economic pull could extend well beyond legal and accounting services, but to call centres, ABM service providers, cheque printing companies among
Since 2002, the share of total Ontario employment in manufacturing has fallen from 18% to under 14%, as more than 200,000 net jobs have been lost in the sector. Yet Ontario is in good company with other advanced economies with respect to manufacturing employment reductions since the start of the decade (see chart). The story boils down to one of survival. Increasing competition from low-cost Asia, notably China, has been putting significant pressure on manufacturers in the industrialized world to compete. And many have been increasingly taking advantage of global supply chains and shifting employment to the developing world.

A look back further over time shows that these trends have been in place well before the start of this decade. However, Ontario managed to buck the trend during the 1990s toward declining shares of manufacturing in employment and output, supported in part by the advent of NAFTA and an undervalued Canadian dollar. In several industrialized countries – such as the U.S., U.K. and Australia – jobs in manufacturing as the share of their respective totals has fallen to about 10% or about 4 percentage points lower than Ontario’s prevailing share. This suggests that Ontario still has quite a bit of job shedding to go if it mirrors those experiences. Assuming that total employment grows at a moderate rate of 1-1.5% per year, Ontario would experience a further job drop of about 250,000 over the next half decade.
From this point, the challenge will be to nail down the gaps from Ontario’s current path and how policies should be altered in order to close those gaps. In the following section, we highlight a number of key themes that we believe will need to form the cornerstone of the vision and where some of the current shortcomings in policy lie.

**Top quality labour force**

Suffice to say that Ontario is hitting the ground running in a number of these areas. One in particular is post-secondary education (PSE), where an enormous turnaround has taken shape over the past half decade. In Budget 2004, the Ontario government appointed a review panel, chaired by former Premier Bob Rae, to examine and make recommendations on the design and funding of Ontario’s PSE system. Proposals included:

- significant new funding in PSE by the Ontario government;
- a call for the federal government to ramp up its funding;
- allowing institutions increased flexibility to set tuition fees, conditional on a commitment to increased provincial funding;
- reforms to provincial and federal student financial assistance programs with a particular aim to raise participation rates among lower income individuals;
- increased cooperation across university and colleges to ensure students can transfer;
- the establishment of a new Council on Higher Education to monitor and report on progress;

The review exercise was extremely successful, receiving widespread acclaim across the province, notably within the sector itself. It was not just the soundness of the proposals that were lauded, but the process itself. Past special-purpose advisory commissions in Ontario took ages only to issue recommendations that fell on deaf ears. In contrast, the Rae Review took less than a year to complete, and that was despite still touching all the bases with respect to public consultations and researching best practices around the world.

Above all, as one of the members of the panel, it was particularly gratifying that most of the Rae report’s key
recommendations have been implemented by the Ontario government – the bulk of which appeared almost immediately after the report’s release in the 2005 budget. Provincial funding was increased sharply, although over five years rather than the proposed three. A regulatory framework has been established to guide and allow institutions to make decisions about tuition levels, albeit under an annual cap of 4-5%. The Higher Education Quality Council of Ontario was set up to track progress in the sector. Furthermore, the federal government has followed up with further funding for PSE, partly through a move to implement per-capita education funding within the Canada Social Transfer (CST). The federal government also funded the Canadian Council on Learning (CCL) to gather and disseminate information on the quality of education and training across Canada. The status of funding beyond next year is, however, uncertain at this time.

The big task ahead is to ensure that the momentum continues, real progress is made and any departure from longer-term goals is promptly addressed. By no means is the funding issue entirely resolved. According to the Institute for Prosperity and Competitiveness, recent funding commitments have still left Ontario institutions with lower revenues per student – both public and private – than many of their competitors in the United States. And, Ontario stands out as being among the few Canadian jurisdictions poised to record higher enrolment rates over the next several years, which will continue to place pressure on the system. Some areas remain a work in progress. For example, one particular aspect of the Rae Report that remains on the “to do” list is the need to sort out the specific roles of colleges and universities and credit transfer.

Clearly, a comprehensive strategy aimed at developing the work force of the future would require focus on a host of other areas, including a lowering the still-lofty high school drop out rate, raising commercialization rates of PSE research, lifting apprenticeship completion rates and private-sector training budgets. Above all, more effectively inte-

The recent economic plight of immigrants leaves much to be desired. This fact is evidenced in Statistics Canada’s report based on 2006 Census data, “Earnings and Incomes of Canadians over the Past Quarter Century,” which tracked the fate of immigrants who arrived during the 5-year period 2000-04. The numbers in the study are national in scope. However, the conclusions can reasonably be extended to Ontario, given that the province accounts for roughly half of total international migration to the country. Highlights include:

- Earnings disparities between recent immigrants and Canadian-born workers increased not only during the past two decades, but also in recent years;
- In 2000, recent immigrant men earned 67 cents for every dollar earned by their Canadian born counterparts, compared to 85 cents in 1980. In 2005, the corresponding number had fallen to 63 cents.
- For immigrant women, the earnings share of Canadian-born fell to 65 cents in 2000 from 85 cents in 1980. In 2005, the respective share was 56 cents.
- The gap in median earnings between recent immigrant men and women and their Canadian-born counterparts widened both for individuals with a university degree and those with no university degree.
- Recent immigrants faced a very high low income rate as defined as per cent below the after-tax low income cut-off. For those arriving over the past five years, the low income rate was about three times the 10% low income rate for Canadian-born persons.
- While this low income gap narrows every additional year an immigrant has lived in Canada, it remains positive. For example, immigrants who have been in Canada for 10 years face a low income rate of 20% and, after 15 years, 16%. 
grating immigrants must be at the forefront of the agenda. We turn to that next.

**Knock down barriers to immigrants**

Virtually all of Ontario’s net labour force growth between now and 2020 will come from immigrants. Yet these individuals have been suffering economically, including—and indeed especially—the so-called “economic class” (see the box on page 10). The difficulty of evaluating international work experience, the mismatch between that experience and present Canadian labour demand, language difficulties and a lack of foreign credential recognition have been key impediments to immigrants’ ability to good-paying jobs in their chosen fields.

Some encouraging steps have been taken in recent years to alleviate the problems at hand. Settlement service funding and language training were boosted as part of the $1 billion Canada-Ontario immigration agreement reached in 2005. Yet it is unclear how far these moves will go towards achieving their desired goals. Part of the challenge has been immigrant selection. And in that vein, the federal government has recently introduced changes in an attempt to lower the backlog of immigrants (estimated to have reached almost 1 million) and to increase flexibility of the Ministry to target certain skills depending on national needs. The logical next step will be to consult with the provinces such as Ontario in order to ensure that priorities are consistent.

The experience of immigrants reflected in the 2006 Census underscores the need for the active involvement of Ontario in selecting the individuals who can best contribute to the economy. In view of the booming market for information technology in the late 1990s, Citizenship and Immigration Canada targeted international workers with web site and computer backgrounds in the early 2000s. In fact, between 2000 and 2005, about half of recent immigrant men with a university diploma had a degree in either computer sciences or engineering. The problem was that the market for those individuals had been evaporating following the high-tech bust, sending median incomes for these groups down by 20-30% over the first half of this decade.

In 2007, Ontario has joined other provinces by launching a Provincial Nominee Program (PNP). A great advantage of this program is that provinces can identify immigrants who would likely have success in the labour market and put them on a fast track for acceptance. In its first year, the pilot program targeted 500 applicants within 20 specific occupations in health, education, manufacturing and construction sectors. KPMG has been contracted to carry out a first year evaluation of the program. Our hope is that the PNP will be expanded and broadened to other sectors in short order.

Meanwhile, children of immigrants are doing reasonably well in school, but the progress of some is being held back due to insufficient resources for ESL. Further support for community programs (Pathways to Education) and public-private groups such as the Toronto Region Immigrant Employment Council will become increasingly critical going forward.

**World class infrastructure**

The long steady deterioration in the state of Ontario’s infrastructure is being reversed. All three levels of government have been moving by the beat of the same drum in recent years—a reflection of the groundswell of public concern about the issue and the recognition that infrastructure is vital to economic advantage and overall quality of life.

A sizeable share of new public capital investment since 2003 has been earmarked for health care and education facilities across the province, although the need to tackle transportation challenges has also shifted to centre stage. Efforts to develop a new border crossing at Windsor continue, although foot dragging in particular on the U.S. side has slowed progress. And steps have been taken to develop a region-wide transportation plan through the creation of Metrolinx, which was set up by the province but
consists of municipal representation.

Last week, Metrolinx released its draft integrated transportation plan for the GTA mapping out some $50 billion in projects over the next 25 years. A final plan will be released later this year following public consultations. However, in our view, the plan is unlikely to proceed under current circumstances:

- The current governance structure needs to be altered to include representation by the province and the private sector. Given their varying interests, it is unlikely that the mayors on the board will agree on the plan’s details.

- Not only does Metrolinx lack the legal authority to get things accomplished, funding for the plan (amounting to $11.5 billion or about one-fifth of the total) will likely have been fully used up by 2013. Efforts to secure project funding provides early assurance that a complete plan can be carried out and that there is value for money. Put another way, it reduces the risk of a fiscal hangover at the end.

- The current configuration of Metrolinx is not conducive to private sector funding of public transit projects. There are undoubtedly many aspects of the plan where it would be efficient to fund through the private sector. Indeed, it is likely that parts of it could be hived off and done virtually completely as private operations.

- A public transit plan must be put in a broader policy context including land use and private transportation policies. Metrolinx does not have the authority or governance structure to ensure complementarity across policy areas. A number of policies encourage urban sprawl, such as property tax structures that give incentives to move jobs out of the city core. By only having control over public transit, Metrolinx’s plan would inevitably exacerbate sprawl and the negative externalities it inflicts by making it more convenient for people and companies to locate further away from Toronto.

- Public transportation must be put into a context of all modes of transportation and how they are costed. For example, the opportunities to cost recover through rider fees on public transit is determined to a degree by the cost of private transit. With the use of road tolls, local gasoline excise taxes and/or registration fees, there might be more scope to cost recover. As well, these type of broader transit policies could support the objectives of moving people from private to public modes and, hence, be complementary with the Metrolinx Plan.

In sum, these issues greatly lower the chances of success of the regional transportation plan. Metrolinx requires legal authority, long-term funding and a provincial leadership role. And there needs to be greater recognition that the massive funding requirements will require a draw on private resources.

On a more positive note, the provincial government’s alternative financing and procurement (AFP) program, delivered through Infrastructure Ontario, has been gaining traction, with some 40 public-private projects under consideration or already closed. Still, most projects to date have been centred on health, education and other “social” infra-

* 3 Yr moving average; Source: Statistics Canada

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![Graph of Government Capital Spending in Ontario](chart)

**Ontario AFP Projects by Sector**

<table>
<thead>
<tr>
<th>Sector</th>
<th>% of projects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health</td>
<td>86.4</td>
</tr>
<tr>
<td>Courthouse/Security</td>
<td>7.3</td>
</tr>
<tr>
<td>Nuclear Procurement</td>
<td>2.4</td>
</tr>
<tr>
<td>Youth Centre</td>
<td>2.4</td>
</tr>
<tr>
<td>Highway Services</td>
<td>2.4</td>
</tr>
</tbody>
</table>

*Includes 41 projects under construction, RFP, RFQ, and pre-tender stages; Source: Infrastructure Ontario
structure. An expansion into other areas, notably transportation, would be warranted. At the local level, the degree to which the private sector’s expertise and resources have been leveraged has been minimal on the whole.

In recent years, municipalities have received significant new money for capital needs from both the federal and provincial governments – including the recent $1.2 billion one-off provincial commitment earlier this month – which has helped them to address at least part of the backlog. Many municipalities have been moving down the path of full-cost pricing of some services, notably water, which has helped to ease the overall funding burden, is more efficient and boosts conservation. Meanwhile, it is increasingly being recognized that world-class talent is drawn to cities with abundant amenities. The Lake Ontario waterfront should be one of those amenities, but progress is coming at a glacial pace. An outstanding issue is the need to finally sort out roles and responsibilities of the two levels of governments. The much-awaited “Who Does What?” report by the Ontario government has been delayed until late 2008. One crucial item that hopefully will find its way in that report is a plan to fully upload social service costs from municipal governments.

In short, the requirements for additional infrastructure investment are huge. And billions of dollars are now being allocated, with the hope that governments at all levels and the private sector will continue to step up to the plate with substantial additional support in the coming decade. It shouldn’t be concluded, however, that all of the funding is being – or will be – spent efficiently. We recommend that some process be put in place to monitor whether taxpayers medium-to-longer term goals are being achieved and whether taxpayers are receiving value for money. This recommendation is more directed at traditional public procurement projects, since AFP projects are already closely scrutinized on the “value-for-money” test. But even there, the focus has been on what return will be generated by the project rather than a broader assessment that would consider whether another type of infrastructure would generate a higher rate of return to society.

**Reliable electricity supply**

A stable electricity supply is another vital element to longer-term economic prospects. In Ontario, concerns about the reliability of the power system have been raised since the 2003 power blackout, which cast attention on the untenable underlying trends of growing demand and declining supply. Since 2003, the Ontario government has taken some action to put the system on a more sustainable footing, and last year, unveiled a 20-year plan that included a goal to increase conservation and renewable energy sources. New nuclear and natural gas supplies are also a cornerstone of the government’s long-term power strategy.

The long-term plan was a major step forward. Now the hard work begins in laying the foundation for the achievement of the objectives. The big challenge comes in 2014, when the province has set a goal to fully phase out 6,400 megawatts of coal generation (about one-quarter of total supply). Given that renewable sources can only fill part of the gap, this will require securing significant new natural resources.
gas sources. The government is also planning major investments in nuclear power over the long haul, but much of that capacity won’t come on stream until 2018.

We concur that demand side management has to play a major role in achieving the long-term goal of a reliable electricity system. We laud the government for beginning the process of moving towards the true cost of power. But despite these moves, power prices are still heavily subsidized. Estimates of the underlying power subsidy – including Hydro’s low royalties for water and OPG’s below-market return on equity – range from $2 billion per year to as high as $8 billion. A significant share of this implicit subsidy relates to the province’s experience with nuclear power. As such, there are some concerns that the government’s decision to invest heavily in existing and new nuclear assets will run contrary to the objective of lowering the degree of subsidization in the system.

An environmental leader

There have also been some positive steps taken on the environment file. Ontario has set a long-term goal to reduce greenhouse gas emissions (GGEs) to 15% below 1990 levels by 2020 and has been exploring partnerships, including the Western Regional Climate Initiative and developing California-style fuel standards. The government has provided a general roadmap of how it will get there. About 30%, for example, is expected to come from phasing out coal generation and increased use of renewable supplies. And spurring innovation will be a major thrust. Still, the devil remains in the details.

In our view, the best way for the province to achieve its long-term GGE objective would be to put a price on carbon. This could be accomplished through various means, such as regulation (i.e., building code standards, vehicle fleet emission targets et cetera), cap-and-trade or carbon tax. Cap-and-trade and carbon tax aren’t all that different, especially if the emissions caps are auctioned. Indeed, Ontario has already indicated an interest in cap-and-trade in partnership with other North American players. One challenge with the cap-and-trade option is that it may be a fractured market and could take a while to mount. For that reason, the Ontario government might want to take a close look at what the B.C. government has been doing, which is essentially a mix of all three options.

Still, it is the new B.C. carbon tax that has generated particular attention given that it is the first one of its kind in North America. This year, the B.C. government moved to extend taxation from gasoline and diesel to all fossil fuels – about 19 in total. These include: transportation and power generation fuels, and home heating oil. The tax begins at $10 per metric ton of CO2 equivalent and will incrementally increase to $30 in five years and will raise close to $1.5 billion per year in revenues when fully implemented that will be recycled back to taxpayers in the form of lower taxes. For Ontario, the driving force behind a carbon tax is not merely to generate revenues for government, but to effectively achieve behavioural change. Moreover, it could create a source of funds for other elements of a sweeping economic plan.

More generally, economics and environmental objectives coincide in requiring drastic cuts in Ontario’s dependence on fossil fuels. The U.S. is finally coming to the
realization they have to wean themselves off oil dependency. Ontario is in the exact same position. In terms of electricity, the province has greater control, since power is largely sourced domestically. But, as we’ve argued, it has to ensure adequate supply and it can’t do that under heavy subsidization.

**Competitive tax system**

When Ontario was able to exploit advantages from sources such as the Canada-U.S. auto pact, low energy costs and an often under-valued dollar, it was not so imperative that its tax system be competitive. Those days are gone. Ontario will not be successful in retaining existing businesses and attracting new ones if its taxation system is not on sound competitive footing with other provinces and countries. The reality is that most other jurisdictions are lowering their tax burdens, particularly on business capital. On that front, Ontario is moving into a high tax relative position, despite some positive steps it has taken, including a phasing out the capital tax by 2010, substantially reducing the education portion of business property tax rates and introducing a number of measures to lighten the burden on manufacturers.

At a minimum Ontario has to play catch up, but the aspiration should be for a corporate tax system that provides a distinct advantage both in Canada and abroad. In view of the shifting landscape in Canada, this requires a provincial statutory corporate tax (CIT) of no more than 10% compared to their current rate of 14% (12% for manufacturers). This move, together with reductions at the federal level, would leave the combined federal-provincial CIT rate at 25%, positioning the province well to attract new investment. Other areas also need to be addressed:

**First**, a retail sales tax, where almost half of the revenue comes from capital and other business inputs, has no place in a modern economy. This major impediment could be addressed by replacing the PST with a harmonized 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. In our view, such a move would be a win-win for business, households and governments over the longer run. In the short-term, it would spur business investment, setting the stage for household and government
incomes to rise down the road. If the retail sales tax was harmonized with the GST, a short-term decline in revenues would likely require some offsetting federal support over a transition period. One concern of such a reform is that the tax base would broaden the base of taxation to many services, hence shifting the burden from business to households. However, this shift is only superficial since businesses would pass through the tax savings, as they did when the federal government and 3 of the Atlantic provinces shifted to the GST in the 1990s.

The positive impact of such a move on Ontario business competitiveness can not be understated. The federal government has estimated that if Ontario were to eliminate its retail sales tax on capital goods, Ontario’s marginal effective tax rate on investment (METR) would fall by a stunning 11.2 percentage points, to 30.7%. Incidentally, Ontario’s average METR on investment conceals a large divergence between effective rates on manufacturing and forestry, which are well below average, and other sectors, which are well above. Ontario has to be careful not to heavily tax the areas that, as we argued above, will likely be the future of growth in the province.

Second, many municipalities in Ontario have unfair property tax structures that over-tax industrial/commercial in favour of residential and multi-residential in favour of singles. In 2007, the Ontario government’s commitment to decrease the Business Education Tax (BET) rate on non-residential properties to 1.6% by 2014. In line with the Ontario Chamber of Commerce, TD Economics recommends that the province accelerate this timetable.

Third, the government should move to address the “small business claw-back”. More specifically, small businesses in the province face a surtax of 4.67% on the income that surpasses the eligible small-business threshold of $500,000 up to $1.5 million. This increases the tax rate more than three-fold (from 5.5% to 18.67% for general and to 16.67% for manufacturing businesses). For income levels above $1,500,000 the regular general tax rate of 14% or the manufacturing tax rate of 12% applies. Income exceeding $500,000 should be taxed at the same marginal corporate income tax rate, which as we discuss, should ultimately be reduced to 10% for all businesses.

On the personal side, the province has very high effective marginal rates for all income groups. Most attention is placed on the onerous top marginal tax rate of 46.4 per cent (combined federal-provincial). This is above the rate in Western Canada (Alberta is at 39 per cent) and considerably higher than those in many U.S. states. But the highest rates are at low and modest-income levels due to the claw-backs on social benefits as income rises. Many individuals and particularly families below average incomes face marginal effective personal income tax rates in excess of 100 per cent. The highest rates, when consideration is given to the loss of in-kind benefits, are usually for those who attempt to exit welfare for paid work.

The Ontario government improved this situation when it reduced the tax back rate on the earnings of social assistance recipients from 75 to 50 per cent and extended dental care. But still many individuals and especially families are in a worse bottom line financial position taking a low-paying job rather than being on welfare. The incentives for work and to improve human capital in the interest of earning more need to be sharpened.

Enhance trade

In order to open up doors for Ontario export-oriented industries, the federal government needs to intensify efforts to reach new bilateral trade agreements. The country can no longer just rely purely on the United States for trade opportunities. Nor can it sit back waiting for large multilateral international trade agreements to be reached, as was made apparent in the recent collapse of both the Doha trade discussions and those towards reaching a Free Trade of the Americas (FTAA). Talks are being conducted at varying levels about varying degrees of liberalization with countries such as South Korea, Japan as well as a number
of South American and Asian jurisdictions. While positive, there is little to show for these efforts as of yet. Indeed, prior to the free trade agreement reached in 2007 with four European countries (Liechtenstein, Iceland, Switzerland and Norway), the federal government had not signed a bilateral deal since reaching one with Costa Rica in 2001.

While the agreement with the four European countries was a step forward, a much greater milestone for both Ontario and Canada would be the European Union, with its vast marketplace and reasonable access through the St. Lawrence Seaway and Atlantic Gateway transportation corridor. On a positive note, preliminary trade talks between Canada and Europe appear set to begin after the federal election in mid-October, raising hopes that a deal could be in the offing. A long-term vision would also set as a high priority increased Canadian increased access to the booming markets of China, India and emerging economies. The recent widening in the Suez Canal, along with moves to knock down trade bottlenecks as part of the federal Pacific Gateway Strategy, will help to pave the way for increased trade between Ontario and Asian countries.

There are also significant trade opportunities at home. In 2006, Alberta and B.C. established a framework and timetable to knock down trade barriers and create a market larger than Quebec (TIMLA). And, late last year, the Ontario and Quebec governments signed a joint declaration to begin negotiating a trade accord that would knock down trade barriers and improve labour mobility. That move followed a cooperation agreement penned the prior year between the two provinces. Ultimately, the goal should be to press for a pan-Canadian free trade deal, including stepped up efforts along with the federal government to promote the creation of a common securities regulator.

**Shifting from Dependence to Work**

Another critical plank in any comprehensive economic vision is a bold anti-poverty strategy. In recent years, the provincial and federal government has been chipping away at the challenge. Initiatives include the Ontario Child Benefit, the federal Working Income Tax Benefit, increased federal and provincial funding for affordable housing, increases in the minimum wage and a provincial dental plan for low-income working residents.

We have already touched on some of the barriers with respect to education, effectively integrating immigrants and excessive marginal effective tax rates at the low end of the income spectrum. But more generally, there is a need for an overhaul of incentives in income security. The first safety net, employment insurance, only covers just over 40% of Ontario’s unemployed. As a result, many individuals fall fairly quickly to the second net, welfare. But that only applies if the person or household has almost no assets, since under the current system, welfare recipients in the province are only allowed to accumulate savings the equivalent of 1-2 months’ worth of their monthly cash allowance. The problem is that without assets there is no ability to withstand even short periods without employment. And without assets, it is extremely difficult to exit welfare. For example, if a car was required for a job the person would not have the savings required to purchase one.

At the end of the day, taking on work often leaves the person or household in a worse overall financial position
due to the combination of income and loss of in-kind benefits (such as health care on welfare, possible access to subsidized housing, et cetera). The recent extension of dental coverage to low-income people rather than to just those on social assistance has been a step in the right direction. Going forward, enhancing federal employment insurance coverage of non-voluntary unemployed workers and the development of a welfare assets strategy should be at the top of the list.

A further more general observation is the myriad of federal and provincial programs targeted at low-income individuals, which could be made more effective through consolidation. For instance, federal tax benefits, allowances, credits and other income assistance could be brought together as part of an improved Canada Child Benefit. Disability pensions, insurance, allowances and social assistance programs could also be folded into a national disability support program. At the provincial level, there has been broad support among anti-poverty groups for a new housing benefit for all low-income households. Such an initiative could be strengthened by including the shelter allowance for welfare recipients under a single program.

Poverty is an excellent example of a challenge where a number of pieces have been put into place, but where more parts are needed and a comprehensive plan developed. The Ontario government had planned to unveil a major poverty initiative later this year, but is likely to be scaled back due to rising economic and fiscal uncertainty. We believe that there is no better time for action than the present.

Supportive federal policy

Last, but certainly not least, a critical part of the long-term Ontario strategy is supportive federal policy. One major challenge on this front is the significant net withdrawal of federal funds from the Ontario economy. Based on the most recent data from Statistics Canada’s Provincial Accounts, federal revenues from Ontario exceeded federal spending in the province by $21 billion in 2005. Only part of this amount could be argued as “discrimination”:

- $1.2 billion reflected Ontario’s population share of the federal surplus in that year on the same accounting basis. That should be deducted from the total.
- An even larger amount – $6.7 billion – reflects revenues collected in Ontario in excess of Ontario’s per capita share. Given that there are no aspects of federal taxation that specifically target Ontario taxpayers, this should also be deducted.
- On the spending side, about $1 billion of the excess represents the combined impact of above-average incomes in the province on payments made under Old Age Security, the Child Tax Benefit and the GST tax credit. The net federal take on both the revenue and spending sides driven by Ontario’s superior economic standing within Canada will diminish and perhaps even swing to a net contribution if Ontario’s under-performance within Canada continues.
That leaves about $11.8 billion where there may be a compelling story of “discrimination.” Much of that is in transfers where Ontario receives some $7.1 billion less than its population share. However, since 2005, the federal government has announced that it would move immediately to per-capita funding for the CST, restoring about $300 million. It also announced a similar move under the Canada Health Transfer (CHT) – worth about $700 million annually – but delayed that until fiscal 2014-15. This has been, and will continue to be for several more years, blatantly unfair to Ontario and should be rectified immediately. Within the employment insurance program, Ontario received $1.2 billion less than its per-capita share in 2005. The current link between hours worked and regional labour market conditions needs to be modified to increase the portion of unemployed qualifying for benefits.

The immediate move to per-capita funding in health and addressing the shortfall in employment insurance benefits (which Ontario has more recently estimated at close to $2 billion) are key elements of the Ontario government’s current push for federal fairness. In addition, the Ontario government has argued that compared to benefits received in other parts of Canada, the province is shortchanged about $500 million annually for training and cumulative amounts of $1 billion under the Building Canada Infrastructure plan and $150 million for immigration settlement services. Lastly, the Ontario government has asked that the federal government to establish an economic development program as it has for all other regions of Canada.

In sum, a large share of the $21 billion shortfall amounts to Ontario financing a substantial portion of the re-distribution role the federal government plays across provinces. In total, the net federal withdrawal amounts to 4% of Ontario GDP, which is a considerable amount that is not available to meet the province’s needs. Although the government and its residents should be applauded in playing such a major redistribution role, Ontario faces a need to be competitive with other provinces and most other countries.

MONEY, MONEY, MONEY

An overnight shift to the desired state we have described would be very expensive. Yet the Ontario government is likely to find itself with shrinking fiscal wiggle room over the next few years, as we show in the accompanying TD Economics’ 5-year “status quo” fiscal forecast.

The revenue and expenditure forecast was compiled by using the government’s own 2008 budget estimates for fiscal years 2008-09 to 2010-11 and revising them to build in new information since the spring. In particular, the final figures for fiscal 2007-08 were released last month, revealing a higher-than-expected budget surplus (excluding the impact of one-time year-end spending measures) and, thus, stronger momentum than initially projected in the spring. However, this was more than offset by the impact of a deterioration in nominal growth prospects for 2008 and 2009 – by about 1 percentage point per year as forecast by TD Economics. Revenues were also adjusted upward by $400 million in fiscal 2010-11 to reflect our forecast that Ontario is poised to become an equalization-receiving province.

In extending the forecast horizon to fiscal 2012-13, we have assumed that the underlying revenue base grows at a moderate rate in line with nominal GDP and equalization payments to Ontario jump to $1.3-$1.5 billion per year. On the spending side, we have grown health care spending by 6% per year (the “status quo” pace) and other spending by about 3%, or stable on a real per-capita basis.

Under these assumptions and applying the balanced-budget constraint, Ontario will have no room for additional measures above and beyond those already committed to this fiscal year and next. A small surplus opens up beginning in fiscal 2010-11. But even then, there is not much spare cash in which to aggressively tackle the big challenges on the province’s doorstep.

However, the province can still make a significant downpayment on an economic vision. For one, the move to accrual accounting in recent years will help the province to
undertake capital spending without a significant short-term budget hit. But there are specific actions that could be taken in order to both generate additional fiscal room and to embark on its vision over the next several years:

- Consistent with our 5-year forecast exercise, the government is urged to increase its budget planning horizon to five years from the customary two. Actions could be back-end loaded to some degree within that time frame, but there must be enough action in the short term that the exercise doesn’t lose credibility.

- The government should consider eliminating its annual reserve allowance, currently set each year at around $1 billion. In recent years, government budgets in Canada have erred on the side of caution in budget planning in order to virtually rule out the possibility of a budget deficit. That mindset has resulted in the setting aside significant buffers for unexpected events. While this recommendation is made with some reservation and is most definitely not an invitation to return to an era of fiscal recklessness, we believe that policy measures, notably those aimed at improving tax competitiveness, would be a better use of resources at this time. In any event, an unanticipated fall into a deficit position would have little impact economically, as long as it is modest and not allowed to continue indefinitely.

- Departmental savings can be secured, although in our view that can reasonably be expected to secure only about $500 million per year in fiscal room. In fact, the government should consider appointing an external body to carry out value-for-money audits to ensure that taxpayer money is being effectively spent.

- It is important that the federal government steps up and addresses elements of fiscal “discrimination” with Ontario. An immediate federal plan to return to per-capita block funding for health care – which would amount to about $700 million per year – in our view is the right thing to do. The Ontario government estimates
that a move to per-capita funding would provide the province with an additional $140 million per year under the Building Canada program and $500 million annually for worker training under EI. Other potential amounts include those for immigration settlement and economic development. Lastly, it is our understanding that the federal government has offered provinces compensation for one year’s worth of revenue loss from sales tax harmonization, which we estimate to be about $1 billion. This money would be paid into a trust fund so that the provinces use it when desired. All together, we have factored into Ontario’s 5-year forecast a federal injection of about $700 million in fiscal 2008-09, growing to $2 billion per year beginning in fiscal 2009-10.

A down-payment on the vision

Adjusting the “status-quo” fiscal forecast to build in the impact of these commitments would brighten the profile considerably. As we show in the chart on the previous page, the planning deficits under the “status quo” for fiscal years 2008-09 and 2009-10 would be transformed into surpluses of $1.2 billion and $2.8 billion, respectively. By fiscal 2012-13, $5 billion would be available for available for new tax and spending measures without moving into deficit. It is still a finite amount though, requiring tough decisions on how to be divvied up across the several important policy areas.

In our view, one thing is for sure. Tax reductions need to feature much more prominently in the vision then they have in recent years. We have estimated that between fiscal 2004-05 and fiscal 2008-09, the government had a cumulative $20-25 billion at its disposal to divvy up between tax cuts, spending and debt reduction. Apart from some modest debt reduction, the entire amount went to new spending measures, albeit much of it targeted at valuable priorities such as health care, education and infrastructure. On the revenue side, the sum total of tax cuts that were announced over the period – some $1.5-$2 billion – were not enough to offset the impact of the introduction of the $2.5 billion health-care premium tax in 2004.

For discussion purposes, we propose that the government split the available planning surpluses equally between revenue and spending measures over the next 5 years, allowing for some meaningful actions (about $2.5 billion annually by fiscal 2012-13) on both fronts. In our view, new spending initiatives should encompass further support for education and for municipalities through the further upload of social services from the property tax base. Keep in mind that any new spending would be incremental vis-à-vis that included in the status-quo forecast assumptions. While debt would fall into third place in terms of priority, a balanced budget over the 5-year period would still allow the debt burden to continue on its recent downward track.

Tax cuts need to feature more prominently

As we discussed earlier, the focus on the tax side should be on cutting the most damaging taxes on growth. In our view, with the productivity-impeding capital tax set to be eliminated by 2010, the priority becomes improving business and personal income tax competitiveness – and in particular, lowering marginal rates. Still, the $2.5 billion in annual room afforded under the forecast by fiscal 2012-13 would only allow the government to scratch the surface in terms addressing tax competitiveness challenges. Consider that a move to cut the general corporate income tax rate by 1 percentage point alone would gobble up about one-third of that amount.

There is another option, however. The government might consider bringing on a new revenue stream that could pave the way for these higher-priority tax cuts. Moving to implement a B.C.-style carbon tax, for example, could raise an estimated additional $4-$5 billion per year (when fully implemented) that could then be recycled back to taxpay-
ers through lower income taxes. The introduction of such a tax would bump up the scope for new tax measures to an estimated $6.5 billion by fiscal 2012-13. As we show in the table on page 21, that leeway would allow the government to move on a number of fronts:

First, it would pave the way for a reduction in the general CIT rate from 14% to 10% over the next four years – a cost estimated at $2.5-$3 billion in foregone revenues when fully implemented.

Second, it would allow the provincial government to implement sales tax reform. Harmonizing the provincial sales tax with the GST must be done in a manner that does not inflict a large tax increase on the financial services sector, one of the future sources of growth we have identified for the province. Without a special arrangement with the federal government such a hit is possible because under the existing GST rules the sector cannot receive a credit for any GST paid on inputs.

Third, there would likely be scope to address some other lower hanging and less expensive fruit on the business side, such as accelerating the province’s existing timetable to reduce business education taxes from seven years and the elimination of the small business claw-back.

Fourth, on the personal side, we figure that at least $1.5-$2 billion would be available to put a dent in the major requirements. That is not a huge amount, given that a full-some plan to address the province’s high personal marginal tax rates would run more in the order of $7-$10 billion. As such, the reductions should, at least initially, be earmarked towards lowering marginal personal income tax rates for low- and modest-income earners. Cutting the first tier of income-tax rates and further scaling back the tax-back rate of benefits on the additional income of welfare recipients are two areas deserving attention.

Bare in mind that this simple cost analysis of tax policy measures does not attempt to build in any second-round benefits to the economy and government revenues that would likely flow from the measures. In addition, by considering a carbon tax or another new revenue stream, the Ontario government might have to throw out its commitment for no new taxes.

The bottom line

With much of Ontario’s economic success driven by advantages that no longer exist, a new direction is required. We look to the provincial government to take leadership on this front by developing a vision on where it plans to take the economy down the road. Some of the pieces have already been put in place. But as we discuss, other parts need to be added and all the pieces need to fit together.

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Endnotes

3. City of London, Global Financial Services Index, March 2008
5. Ibid. Ontario Task Force on Competitiveness, Productivity and Economic Progress