TD Bank Financial Group

# TD Economics

Special Report

June 13, 2006

# WHITHER THE ONTARIO ECONOMY?

The Free Trade Agreement and then North American Free Trade Agreement sent messages to the industrial base of Ontario's economy that it was time to stand on its own two feet in open competition with the United States and Mexico. In some respects, such as continuing inferior productivity to key competitor states, the Ontario economy is still wobbling. Now it faces an onslaught of further challenges. Will it prosper or whither? This note assesses these challenges in the context of how the Ontario economy will fare by 2020.

### Ontario's economy has undergone a remarkable transformation

Dating back to the National Policy implemented in 1878, Ontario's industrial base was developed behind trade protection and subsidies. With a high international tariff wall, other provinces became captive markets for Ontario's manufactured products. Automobile production and exports were tilted in Ontario's favour through the Canada-U.S. Auto Pact, signed in 1965. Electricity, a key cost component, was provided to the province's industrial users at subsidized prices.

Little remains of this foundation. The tariff wall is mostly gone and the Auto Pact was struck a death blow by the World Trade Organization in 1999. For every dollar exported from Ontario to other provinces, almost 3 dol-

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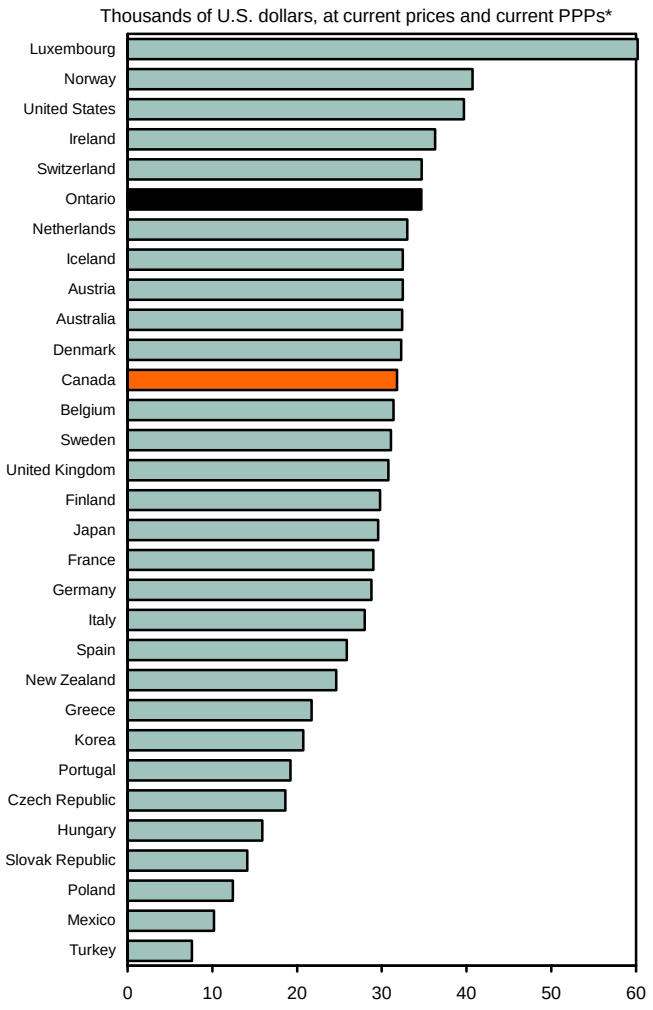
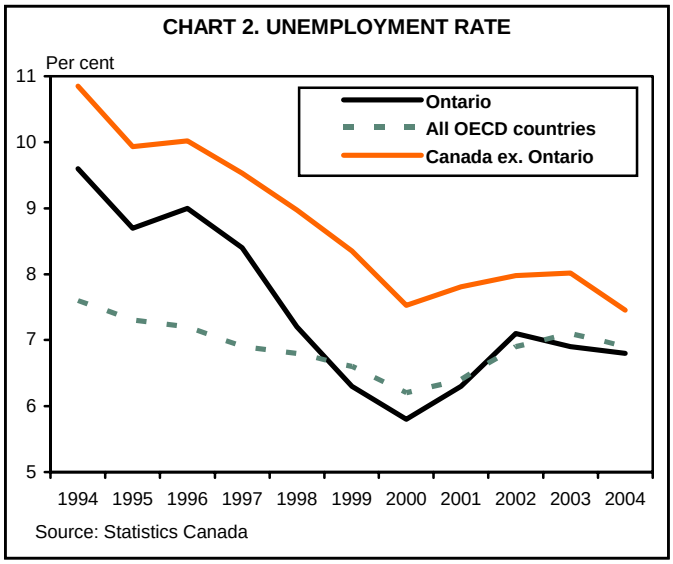
**CHART 1. GROSS DOMESTIC PRODUCT PER CAPITA IN 2004**



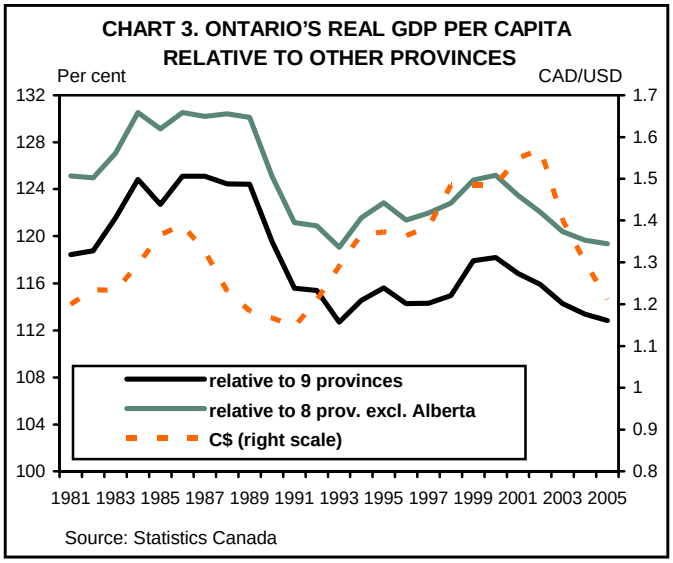



lars is now shipped to the United States. Industrial electricity users are being weaned of price subsidies.

On the surface the Ontario economy appears to have come through the transformation rather well. If Ontario was a country, it would have the sixth highest real GDP per capita among OECD countries (Chart 1). Among countries with similar or larger populations, Ontario would be behind only the United States. The provincial unemployment rate of 6.6 per cent observed in 2005 is slightly below the average of other provinces, similar to the average unemployment rate for the countries in the Organization for Economic Co-operation and Development (OECD) and is down from the Ontario average of 7.6 per cent since the current Labour Force Survey began in 1976 (Chart 2).

Much has been made of the slippage in Ontario's real GDP per capita relative to the Canadian average. Twenty years ago, the Ontario edge was 13 per cent. In 2005 it was down to only 7 per cent. But this measure is flawed. First, as Ontario's weight is 42 per cent in the Canadian average, it distorts the comparison to look at the numeraire as all of Canada including Ontario. Second, Ontario's slippage is in good part due to the Alberta boom rather than Ontario weakness. Ontario still has a 13 per cent advantage in real GDP per capita compared to the average of all other provinces (excluding Ontario). This edge is down from an average of 23 per cent over the 1980s. Ontario's real GDP per capita is 19 per cent higher than the average of the 8 provinces excluding Alberta and Ontario. This edge is down from an average of 29 per cent in the 1980s (Chart 3).

While real GDP is typically used for measuring economic well-being, nominal GDP is also of importance because higher producer prices do filter into higher incomes. Ontario's edge in nominal terms is much less than in real terms because many of the other provinces have enjoyed income gains from rising commodity prices whereas these prices reflect costs to Ontario's industrial base. Ontario's edge in nominal GDP per capita relative to all other provinces (excluding Ontario) is only 2 per cent, the smallest in 25 years of available data. Ontario's advantage against the average of all other provinces excluding Alberta remains substantial at 15 per cent, still the smallest edge since data are available (Chart 4). In the accompanying charts it will be noticed that Ontario's position on real and nominal GDP per capita relative to the other provinces



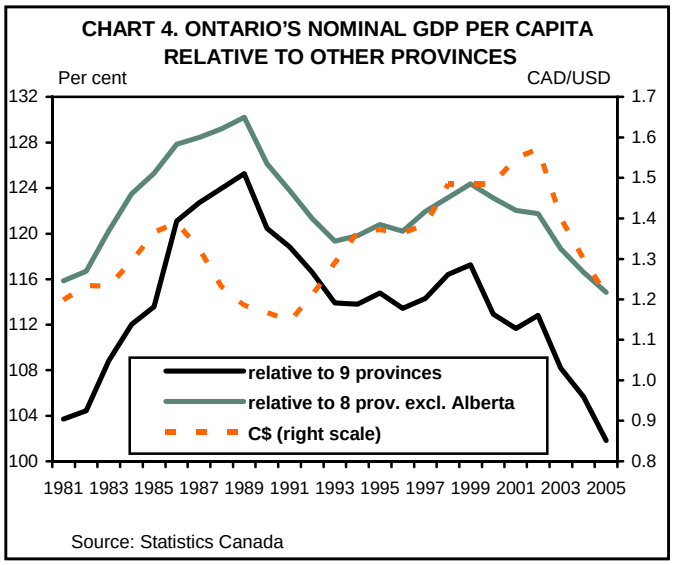
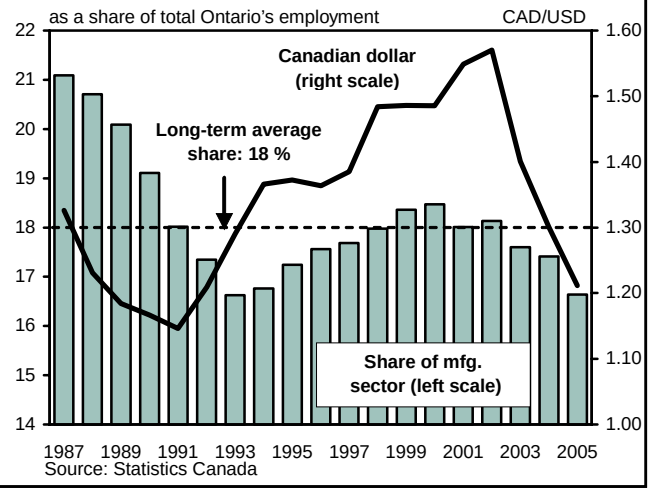
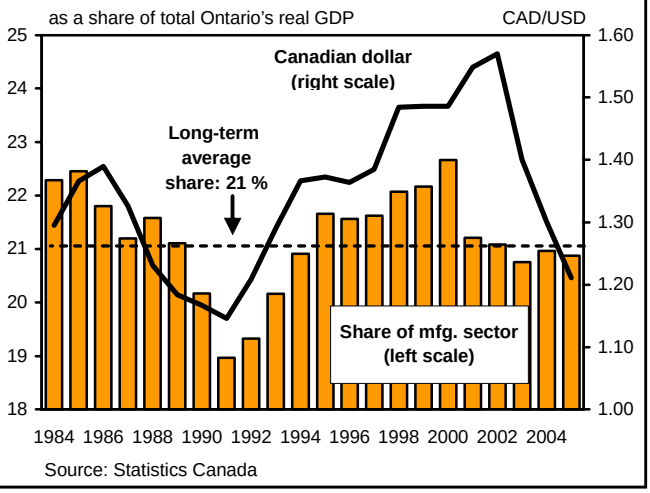



**CHART 5. ONTARIO MANUFACTURING SECTOR AND THE CANADIAN DOLLAR**




Source: Statistics Canada

**CHART 6. ONTARIO MANUFACTURING SECTOR AND THE CANADIAN DOLLAR**




Source: Statistics Canada

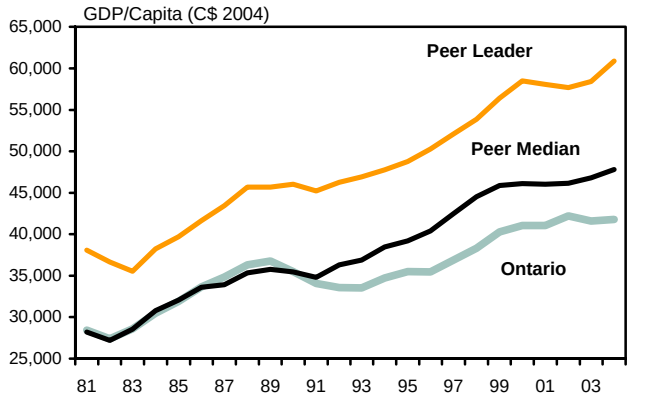
moves in sync with the Canadian dollar (a stronger Canadian dollar tends to coincide with a deteriorating relative position of Ontario). This is not necessarily because Ontario's economy is more sensitive than the rest of Canada to exchange rate movements, Rather, it reflects the tendency for the external value of the Canadian dollar to move with commodity prices. As commodity prices rise, the economies of provinces with substantial natural resources tend to strengthen whereas both the higher commodity prices and the ensuing rise in the Canadian dollar hurt Ontario's industrial base.

Ontario's manufacturing sector and in particular the auto segment are thought by many to be down and out. This may be because the indicator we see most often is employment and the share of Ontario jobs in manufacturing has slipped from just over 18 per cent in the late 1990s and early 2000s to around 17 per cent (Chart 5). Ontario's manufacturing sector has lost 62,000 jobs since the peak employment level in November 2002. But productivity growth has gained some momentum such that output from manufacturing has continued to grow and accounts for 21 per cent of the province's total GDP, identical to the average since 1984, although down from the 2000 peak of 22.7 per cent (Chart 6). The above chart also shows the close tracking of the value of the Canadian dollar against the U.S. dollar and the share of manufacturing in the Ontario economy.

In aggregate the auto industry is faring reasonably well – for example, the share of manufacturing employment and investment in the sector is at an all-time high. Within the auto sector there is a great divide, however, between the performance of the expanding Japanese-based companies and the Big 3 North American companies (see TD Economics, Big Wheels Keep on Turning: Globalization & the Health of the Canadian Auto Industry, May 18, 2006 for a detailed assessment of the Ontario automobile industry).

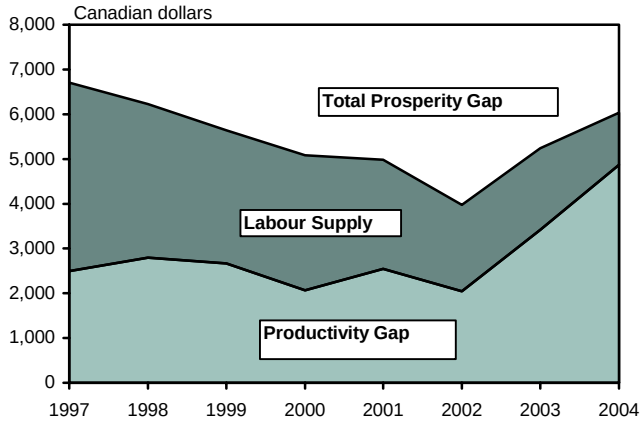
The work of Ontario's Institute for Competitiveness and Prosperity shows that the performance of Ontario's economy still leaves a lot to be desired when benchmarked against competing U.S. states. The Institute benchmarks Ontario's real GDP per capita against 14 U.S. states of similar size and Quebec. For 2004, Ontario was saved from being at the bottom of the barrel only because of

**CHART 7. ONTARIO'S PROSPERITY GAP COMPARED TO PEER STATES***




*16 North American jurisdictions incl. 14 U.S. states, Ontario & Quebec;
Source: Institute for Competitiveness & Prosperity/Statistics Canada

**CHART 8. ONTARIO'S PROSPERITY GAP PER CAPITA**




Source: Institute for Competitiveness & Prosperity/Statistics Canada

Quebec. Until the early 1990s, Ontario's real GDP per capita was close to the median of these 16 jurisdictions but by 2004 it was $6,000 below (Chart 7). Weaker productivity accounts for most of the gap lately. (Chart 8).

### Ontario's economy is facing a fresh onslaught of challenges

Before it has completely righted itself from the transformation to free trade, Ontario's economy is being subjected to a new set of strains, including:

- Soaring commodity prices, which have helped drive the Canadian dollar from 62 cents U.S. in 2002 to around 90 cents U.S. presently;
- There is a new surge of competition from the United States where particularly in the South workers are receiving low wages and few benefits;
- Access to the U.S. market is threatened from U.S. security concerns and congestion at the key Ontario-U.S. border crossings;
- The pressure to increase re-distribution among Canadian provinces risks a further net drain from Ontario's economy;
- There is concern that insufficient new electrical generation will come on stream to keep prices reasonable; and
- A wave of intense competition from emerging economies in south-east Asia threatens Ontario's manufacturing base and aspects of other industries as well.

**CHART 9. APPROACHES TO AN ANCHOR FOR THE DOLLAR**

| | |
|---|---|
| Private Sector Productivity: GDP/Hr. Canada to US ratio | 0.79 |
| Total Labour Compensation Gap: Canada/U.S. | 0.84 |
| Purchasing Power Parity (PPP) | |
| Statistics Canada | 0.85 |
| OECD (2002) | 0.81 |
| IMF | 0.83 |
| Penn World Table - University of Pennsylvania (IMF) | 0.85 |
| Big Mac PPP (*The Economist May 2006*) | 0.89 |

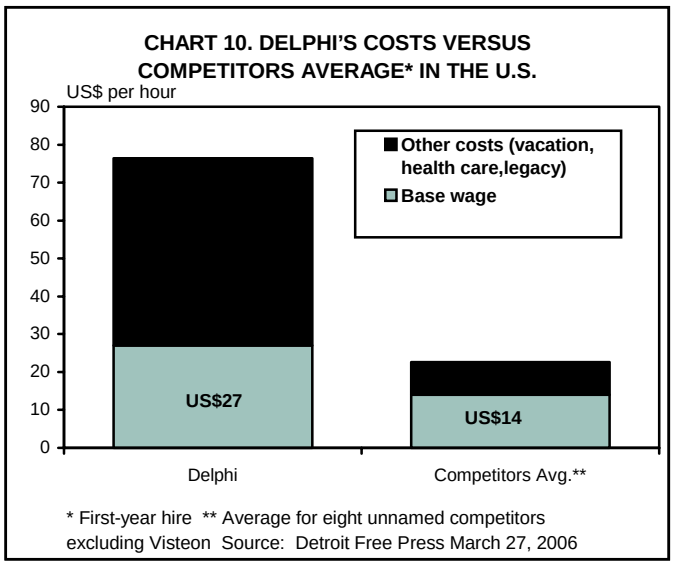
We will assess each challenge in turn from the perspective of what the Ontario economy might look like by 2020.

### The stronger Canadian dollar

The Canadian dollar has risen 39 per cent against the U.S. dollar over the past 4 years. The starting point in the low 60s was surely absurdly low. But by any measure the current level represents a severe challenge to the Ontario economy, at least in the near term. Most estimates of Purchasing Power Parity for the Canadian dollar – the exchange rate that equates costs around the world of producing a common basket of goods and services – fall in the 81 to 85 cent U.S. range (Chart 9). More simply, we note that Canadian output per hour in the private economy is about 79 per cent that of the United States (See TD Economics, Canada's Productivity Challenge, October 5, 2005 for a more complete discussion on Canadian productivity). Such benchmarks for the manufacturing sector and even perhaps for the Ontario economy as a whole are likely below the national figures. So unambiguously the current level of the Canadian dollar is a competitive challenge to Ontario's economy, particularly because of the speed of the ascent.

Fortunately, the private sector is reacting by cutting costs and raising investment. But part of the response is also replacing domestic production with imports.

There is little the Ontario economic players can do about the value of the Canadian dollar. It has been driven up by rising commodity prices and that represents a double shock to Ontario producers because many of them have to purchase the commodities as inputs. If the U.S. economy




slows in the second half of this year, as TD Economics expects due to a softening housing market and consumer indebtedness, commodity prices should fall back. But the downward pressure on the Canadian dollar will be partially offset by the effect that a turn in international investor sentiment against the U.S. dollar will have in pushing the greenback lower (see TD Economics, The U.S. Current Account Deficit: Nothing to Fear But Fear Itself, May 18, 2006 for a detailed description of the vulnerability U.S. indebtedness presents for the U.S. currency). In total, Ontario's manufacturers should not expect the Canadian dollar to fall below 85 cents U.S. any time soon and it could remain well above that as the mirror image of a weak U.S. currency.

### A new wave of U.S. competition

The new wave of U.S. competition could be labeled the 'Delphi effect' after the giant auto parts company that is currently in bankruptcy protection. When the Delphi auto parts workers were part of General Motors their base wage was about $US 40. With Delphi it has been $US 27. But the company wants wages to be driven down to $US 16.50 with concessions on benefits as well (Chart 10). This particular scenario is representative of a polarization of wages that is becoming of growing concern for the Ontario economy. The well-paid unionized jobs with attractive benefits, including defined benefit pension plans, are under siege. In part it is due to its competition from the emerging south-east Asian economies. But in the case of the automobile industry it is also due to competition from foreign-based companies without the pension and medical legacy costs and workers in the United States, particularly in the south, who are accepting low wages and few benefits. It is hard to imagine that the 'Delphi effect' will not spread through the auto industry and into other parts of the North American economy.

### Ontario's economy would be crippled without free flow of goods and services across the U.S. border

The Ontario-U.S. border is the life line of the Ontario economy. Exports account for 69 per cent of Ontario's GDP with the split being 72 per cent to other countries and 28 per cent to other Canadian provinces, with the U.S. being the destination of 93 per cent of external trade. Imports that flow across the border from the United States meet much of Ontario's consumption needs as well as providing key inputs in provincial production. An often cited figure is that $1.2 billion of trade crosses the Canada-U.S. border every day. Less well known is that 60 per cent of all land borne merchandise trade goes through just 3 Ontario-U.S. ports with the Ambassador Bridge spanning Windsor-Detroit alone accounting for more than 40 per cent. Indeed, the Ambassador Bridge is the busiest border crossing in the world.

Congestion with long delays has long been a fact of life at the Ontario-U.S. border crossings due to inadequate staffing and inadequate infrastructure on both sides. A 52 per cent increase in the value of trade by truck between the United States and Ontario from 1994 to 2004 steadily magnified the problems. But it was the terrorist attacks on the United States on September 11, 2001 that finally set off the alarm bells. In the nine months following the attacks, U.S. imports of Canadian goods by land fell by 10.8 per cent. Canadians came to understand that the U.S. was quite prepared to put security interests ahead of commerce. And with the U.S. making it clear it is still not satisfied with Canadian security efforts, the risk that the free flow of goods and services across the border could become even further compromised looms larger than ever.

The Ontario Chamber of Commerce has estimated that delays at the border are costing the Canadian and U.S. economies over $13.6 billion annually, with Ontario absorbing $5.25 billion of that, or $843 for every Ontario tax payer. Yet even this grossly understates the potential cost. The promise of free flows across the border lies at the heart of the North American Free Trade Agreement. The beauty of that pact is that Canada can say to corporations around the world – locate here and you will have

unfettered access to the North American market. That promise rings hollow if the border does not function properly for security, infrastructure or simply personnel reasons. In a world of just-in-time-inventories, few operations can withstand delays in getting their products to market. Uncertainty about border arrangements amount to tariff-like barriers on both exports and imports and will impinge upon Ontario's ability to attract and maintain investments in the province. As such, the border may be the greatest challenge of all for the future of Ontario's economy.

Fortunately, action is being taken to address border challenges. The question remains whether it will be adequate. Between 2002 and 2004 the federal government in cooperation with the provinces and other partners announced more than $1 billion in border infrastructure improvements with the largest share allocated to Ontario's crossings. In the 2006 federal budget, the federal governement announced the creation of a new $2.4-billion Highways and Border Infrastructure Fund. Further, the federal and Ontario governments are moving ahead with the $300 million "Let's Get Windsor-Essex Moving Strategy" which is designed to improve traffic flows to the Windsor-Detroit crossing and expedite environmental and engineering assessments that will lead to construction of an additional crossing. Yet even if all goes according to plan, that crossing will not be in place until 2013. And it is not clear that congestion problems leading to a new crossing will be greatly ameliorated. The Windsor-Detroit crossing is a rarity in not having direct linkage to a highway. Indeed, the feeder route along Huron Church Road essentially has traffic passing through residential areas. A common joke in the trucking business is that there are 17 traffic lights between Ontario and Florida and 16 of them are in Windsor. An additional lane has been completed on the Queenston-Lewiston Bridge and Highway 405 has been expanded leading to that crossing. The new Sault Ste. Marie International Truck Route is nearing completion and improvements are underway on the QEW Niagara and on Highway 402 leading to the Sarnia crossing.

Programs such as NEXUS (dedicated/fast lanes for pre-approved, low-risk travelers) and FAST (Free and Secure Trade pre-approves importers, carriers and drivers to process low-risk goods using dedicated lanes) have cut delays while respecting security needs. Yet the programs are not well known and take up has been poor. The customs broker GHY International estimates there are only 50,000 people with NEXUS and only six per cent of truck drivers eligible for the FAST program are enrolled. The Ontario Government estimates that 30 to 35 per cent of truck drivers arrive at the border without having completed the appropriate paperwork in advance.

**Chart 11. Federal Government Revenue and Expenditure from Ontario, 2003 (Millions of dollars)**

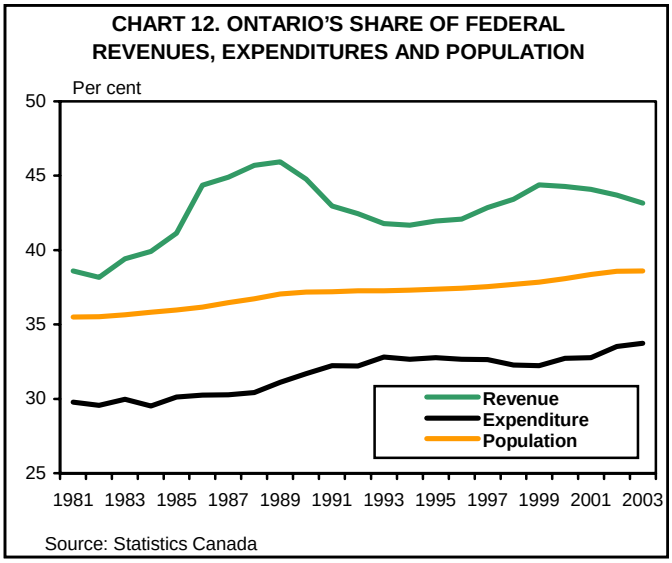
| | Ontario | Share (%) |
|---|---|---|
| **Revenue** | **82,474** | **43** |
| Direct taxes from persons | 40,184 | 45 |
| Direct taxes from coporations | 11,872 | 43 |
| Direct taxes form non-residents | 2,408 | 58 |
| Contributions to social insurance plans | 7,219 | 40 |
| Taces on production and imports | 17,920 | 40 |
| Other curr.transf. from persons | 37 | 65 |
| Curr. Transf. from provincial govts. | 2,773 | 40 |
| | 61 | 8 |
| **Current expenditure** | **64,301** | **34** |
| Net curr. Exp. | | |
| on goods and services | 17,470 | 40 |
| Curr. transf. to persons | 20,447 | 33 |
| Curr. transf. to business | 1,318 | 27 |
| Curr. transf. to prov. govt. | 11,434 | 28 |
| Curr. transf. to local govt. | 49 | 39 |
| Interest on public debt | 13,583 | 39 |
| **Total Net Federal Balance in Ontario** | **18,173** | |

Source: Statistics Canada

Clearly some additional heat is needed to ensure the proper functioning of the Ontario-U.S. border. Canada needs to take additional steps to ensure security – not just to appease the Americans, but for the safety of Canadian citizens as well. Infrastructure upgrading, both bridges and roads, needs to be accelerated and both Canada and the United States need to expand and improve the land pre-clearance programs to facilitate truck traffic. In particular, governments and the private sector need to work together to get to the bottom of why the NEXUS and FAST programs, which appear so promising on paper, have not worked better in practice.

### Pressure for more re-distribution away from Ontario

Ontario Premier McGuinty's '$23 billion campaign' has attracted attention to the drag on the Ontario economy from the federal government's net fiscal take (revenues collected over spending in the province). This $23 billion figure is Ontario's own extrapolation for the fiscal year 2004-05 based on Statistics Canada's figure of $21.2 bil-




lion for 2002, adjusted for taxation and spending initiatives announced in budgets up to Spring 2005. Statistics Canada has since released the figures for 2003 and the excess of federal revenues collected over spending in Ontario was $18.2 billion, suggesting Ontario's estimate may be a bit high for fiscal 2004-05 (Chart 11). The $18.2 billion means that for every dollar of revenue collected by the federal government from Ontario taxpayers, 80 cents was returned to the province in spending.

The net federal take from Ontario has often been misunderstood. Some interpret it as a federal "bias" against Ontario. But a small part of it simply represents Ontario's share of the federal budget surplus. On the accounting basis Statistics Canada uses for the Provincial Economic Accounts that surplus was $2 billion in 2003. Applying Ontario's population share of 39 per cent, $0.8 billion of the federal surplus would be Ontario's share if federal revenue collections and spending were both in accordance with Ontario's share of the Canadian population. But neither is. The federal government collects 43 per cent of its revenues from Ontario taxpayers (Chart 12). The 4 percentage point gap relative to Ontario's population share (amounting to $7.9 billion) reflects the interaction of the federal government's national tax parameters with the higher incomes and particular structure of the Ontario economy. There are no aspects of federal taxation that could be considered as specifically targeting Ontario taxpayers.

The federal government only allocates 34 per cent of its spending to Ontario. Some of this 5 percentage point gap relative to the population share (amounting to $10.0 billion) is due to above-average incomes in Ontario. For example, Ontario receives 36 per cent of federal child care benefits (lowering Ontario's receipt of federal spending $220 million relative to its population share), 36 per cent of Old Age Security payments ($859 million "loss" relative to its population share), and 35 per cent of the low-income GST credit ($145 million "loss" to Ontario relative to its population share) because there are relatively fewer low-income families in the province (Chart 13).

With $0.8 billion of the $2 billion 2003 federal surplus being Ontario's per capita share, and $9.1 billion being the gap on revenues, child tax benefits, Old Age Security payments and the low-income GST credit, we can get down through process of elimination to a net federal take of $8.2 billion where there may be a compelling story (Chart 13). But as with all compelling stories, there are various shades of grey. The clearest element is federal transfers to the provinces. Ontario receives $4.6 billion less than its per capita share would dictate. Most of this results from Ontario being the only province along with Alberta not to receive equalization. But part also reflects federal transfers for health and post-secondary education. While these are commonly thought to be paid to provinces on an equal per capita basis, they are adjusted to equalize the value of tax points transferred to the provinces in 1977 – an adjust-

**Chart 13. Discrepancy Between Actual Amounts from Ontario's Population Share and Hypothetical Amounts from Ontario's Population Share ($ millions)**

| | |
|---|---|
| **(1) Total Net Federal take in Ontario** | 18,173 |
| (2) Ontario pop. share of federal national balance | 786 |
| (1)-(2) = (3) Gap in Ontario's share of Federal Balance | 17,387 |

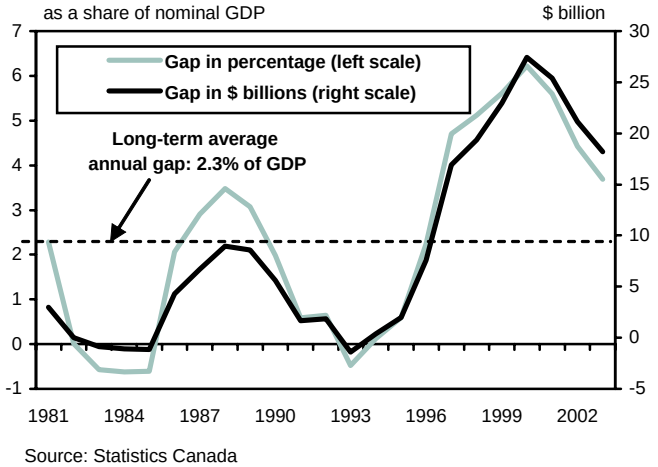
| | Actual | Ont. Share from Pop. | Discrepancy |
|---|---|---|---|
| **Federal Revenues** | **82,474** | **74,552** | **7,922** |
| **Federal Expenditures** | | | |
| Old Age Security | 9,644 | 10,503 | -859 |
| Child Tax benefit/Credit | 2,920 | 3,140 | -220 |
| GST tax credit | 1,128 | 1,273 | -145 |
| Employment insurance | | | |
| (4) Contribution of Items Identified Above to Gap in Ontario's Share of Federal Balance | | | 9,146 |
| **(3) - (4)=(5) Residual Gap** | | | **8,241** |
| of which: | | | |
| EI benefits | 3,923 | 5,211 | 1,288 |

Source: Statistics Canada; TD Economics

ment known as "associated equalization". Ontario estimates it receives $1.1 billion per year less than it would if payments were equal per capita.

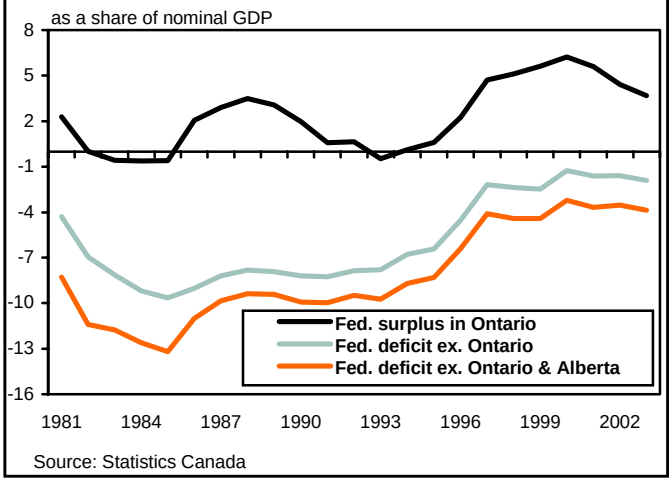
A good example of a grey area is employment insurance benefits. Ontario residents receive 29 per cent of federal payments, or $1.3 billion less than its population share would dictate. In one sense this is simply the application of national parameters to Ontario's labour market. But the result might seem a bit counter-intuitive because as discussed above, Ontario's unemployment rate is just slightly below the national average. Only 27 per cent of the unemployed in Ontario received EI benefits in 2004 – in Toronto it was only 22 per cent. This compares to coverage of 40 per cent in the rest of Canada (See "Time for a Fair Deal", Report of the Task Force on Modernizing Income Security for Working Age Adults, May 2006 for further detail). The low coverage in Ontario stems in good part from Ottawa's requirement of more hours to be worked in order to qualify for benefits in low-unemployment areas, Ontario's disproportionately high share of recent immigrants who tend not to have sufficient hours and from Ontario's higher than national share of self employment, which employment insurance does not cover. The effect is magnified because much of the federal government's training is only available to EI beneficiaries, so here too Ontario residents get a low share. There is certainly room for debate over the degrees to which Ontario's low share of employment insurance benefits and training reflects the legitimate application of national parameters to the particular characteristics of the province's labour force or whether those parameters are inappropriately designed to

**CHART 14. ONTARIO'S GAP BETWEEN FEDERAL REVENUES AND EXPENDITURES**




Source: Statistics Canada

**CHART 15. GAP BETWEEN FEDERAL REVENUES AND EXPENDITURES**




Source: Statistics Canada

support Ontario's needs. Ontario has also been receiving a relatively low share of federal money for affordable housing and immigration settlement (certainly relative to the number of immigrants coming to the province).

Premier McGuinty suggested to former Prime Minister Martin in 2005 that an initial take on the degree of "unfairness" in federal fiscal dealings with Ontario was in the order of $5 billion a year. Such a sum could be derived by adding together the Ontario cost of associated equalization, immigration settlement, affordable housing and a good part of the gap between actual receipts of employment insurance benefits and training and Ontario's per capita share. And indeed the Martin government did take action to address the situation and discussions are underway with the new Conservative Government over details of how these undertakings will be enacted.

A further confusion arises over how to interpret the historical pattern of the net take of the federal government from Ontario. Some suggest this is a relatively new phenomenon since the federal government's balance between revenue collections and spending in Ontario was roughly zero in the early 1990s (Chart 14). This interpretation is entirely incorrect. The gap between Ontario's share of federal revenues and its share of federal spending has been relatively constant for many years (Chart 12). The main thing that has shifted is simply the overall federal budget balance. In 1993, for example, the federal government ran a small deficit of $1.4 billion in Ontario. But it ran an overall deficit across the country of $35.3 billion meaning it was spending $33.9 billion more in the other provinces

**CHART 16. Ontario Government Per Capita Spending in the fiscal year 2004-05**

| | Rank among provinces | Discrepancy from prov. median ($) | Discrepancy from prov. median per cent |
|---|---|---|---|
| **Total** | **10** | **-1,109** | **-14.1** |
| **Program spending** | **9** | **-829** | **-12.1** |
| Health | 4 | 24 | 1.0 |
| Education | 10 | -324 | -20.4 |
| Social Services | 5 | 6 | 0.5 |
| Transportation and Communication | 9 | -78 | -23.1 |
| Other Program Expenditures | 10 | -524 | -37.9 |
| **Public Debt Charges** | **8** | **-246** | **-25.4** |

Source: Financial Management System of Statistics Canada

**CHART 17. Ontario Government Per Capita Revenues in the fiscal year 2004-05**

| | Rank among provinces | Discrepancy from prov. median ($) | Discrepancy from prov. median per cent |
|---|---|---|---|
| **Total** | **10** | **-1,846** | **-22.2** |
| **Transfers from other gvts.** | **10** | **-1,235** | **-55.5** |
| **Own-Source Revenues** | **6** | **-158** | **-2.8** |
| Personal income taxes | 2 | 316 | 21.9 |
| Corporate income taxes | 2 | 232 | 64.3 |
| Consumption taxes | 6 | -21 | -1.1 |
| Royalties and investment income | 10 | -446 | -71.6 |
| Contributions social security plans | 5 | 19 | 9.0 |
| Other own-source revenues | 3 | 421 | 13.9 |
| **Own-source revenues excluding royalties & investment income** | **2** | **449** | **9.2** |

Source: Financial Management System of Statistics Canada

than it was collecting in revenues. Another perspective is that Ontario's per capita share of the federal deficit was $14.4 billion that year but instead it received a net contribution from federal coffers of $1.4 billion.

While the entire $18.2 billion net federal take from Ontario in 2003 certainly does not reflect a federal "bias", it does all act as a drag on the Ontario economy that amounted to 3.7 per cent per cent of its GDP. For the most part, competing U.S. states do not have such a drag because the federal government there does less re-distribution and is running a huge overall deficit (which of course raises its own set of risks). The net federal take from Ontario also puts the province at an economic disadvantage relative to other provinces. In 2003, the federal government ran a net deficit of 1.9 per cent of GDP in all provinces other than Ontario, or 3.9 per cent of GDP if we consider the 8 provinces excluding both Alberta and Ontario (Chart 15). So clearly the federal government does perform a significant inter-provincial redistributive role, largely financed by Ontario taxpayers.

Recently Premier McGuinty has been emphasizing that in some key policy areas Ontario ranks near the bottom of provinces in spending per capita. The message has been that it seems "unfair" for Ontario's taxpayers to be providing so much of the financing for programs such as equalization when they end up with poorer services than the residents of provinces receiving the federal transfers. Implicit in the message is that this is a side-effect of the federal government's net fiscal take from Ontario residents. Some skeptics have suggested that Ontario's low spending in some areas reflects its own budget priorities or its high public debt charges from past fiscal mismanagement. Analysis of Statistics Canada's Financial Management System data, which puts all provincial revenues and expenditures on a common accounting basis, does not support these charges, however.

The Ontario government's total spending per capita ranked 10th among the provinces in 2005, $1,109 behind the 10-province median. By policy area, Ontario was 10th in education and "other program expenditures" and ninth in transportation and communication. It is virtually bang on the median for health and social services. The relatively low expenditures in program areas are not because of large Ontario public debt charges. In fact, Ontario ranks eighth in debt payments, $246 below the provincial median (Chart 16).

Ontario's relative public expenditures are not low because of its overall budget position. Indeed, Ontario is one of the few provinces having a deficit, meaning that its spending exceeds the total revenue intake (As all the data used here are from the Financial Management System, they differ from the figures shown in provincial budgets) (Chart 18). Rather, the explanation is that Ontario stands 10th in total revenue per capita, $1,846 off the provincial median (Chart 17). The weak overall revenue position is because Ontario ranks 10th in transfers from the federal government, with a $1,235 gap from the provincial per capita

**CHART 18. Provincial Per Capita Budget Flows in the fiscal year 2004-05 ($)**

| | Program Spending | Public Debt Charges | Own-Source Revenues | Transfers from other gvts | Budget Balance |
|---|---|---|---|---|---|
| N.&L. | 8,032 | 1,108 | 5,180 | 3,853 | -108 |
| P.E.I. | 7,732 | 827 | 5,019 | 3,192 | -348 |
| N.S. | 5,736 | 1,244 | 5,115 | 2,499 | 634 |
| N.B. | 6,504 | 1,315 | 5,224 | 3,046 | 451 |
| Quebec | 7,638 | 1,223 | 7,127 | 1,416 | -317 |
| **Ontario** | **6,036** | **722** | **5,486** | **990** | **-282** |
| Manitoba | 6,673 | 1,078 | 5,802 | 2,569 | 620 |
| Sask. | 7,056 | 859 | 7,055 | 1,951 | 1,091 |
| Alberta | 7,805 | 218 | 8,286 | 991 | 1,255 |
| B.C. | 6,593 | 591 | 6,169 | 1,233 | 219 |
| **Prov. Median** | **6,864** | **969** | **5,644** | **2,225** | **36** |

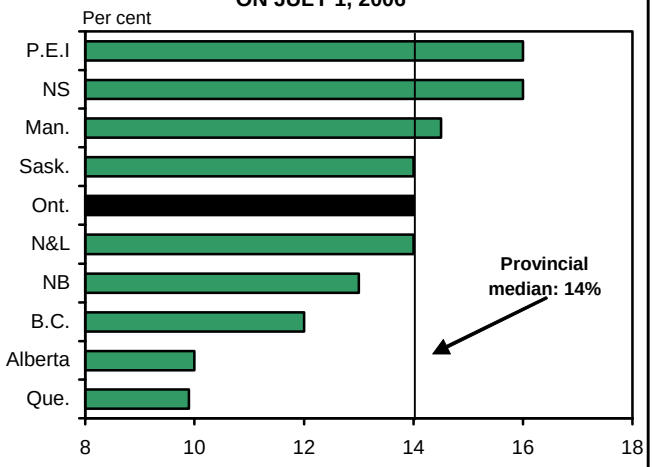
Source: Financial Management System of Statistics Canada

median. Its per capita own-source revenues are only a notch lower ($158) than the provincial median.

Of course it might seem strange that Ontario's own-source revenues are not higher than the median given that Ontario residents have the second highest incomes after Albertans. This is largely due to the fact that Ontario does not have appreciable amounts of oil or natural gas and hence is $446 per capita below the provincial median on royalty collections (and investment income). Excluding royalties and investment income, Ontario's per capita own-source revenues are $449 per capita or 9.2 per cent above the provincial median. In this context Premier McGuinty's concern about a 10-province equalization standard with full inclusion of royalty revenues can be understood. That would raise the bar for the standard to which provinces are to be equalized. But as the federal government, like Ontario, can't get its hands on appreciable amounts of royalty revenues, the cost of the higher standard is effectively borne by Ontario's non-royalty revenues. As those revenues are already above the median Ontario would face substantial competitive pressures – from other provinces and especially the United States – to make up for the lack of royalty revenues by pushing harder on other tax sources. The only source where there might be some scope is on consumption taxes where Ontario's collections are slightly below the provincial median. Ontario's non-royalty own-source revenues are relatively high because of strength in Ontario's tax bases. Ontario's tax rates are above those in some of the other large provinces and in some of the equalization-receiving provinces (Chart 19 and 20). Suggestions have been made that Ontario (and Alberta) should not be concerned about enrichments to equalization because the cost will be borne through reductions in federal surpluses rather than tax hikes that would largely be at the expense of Ontario (and Alberta) taxpayers. Ontario is right to see through this argument. Additional federal expenditures compromise the chances of future federal tax cuts that would disproportionately benefit taxpayers in Ontario (and Alberta).

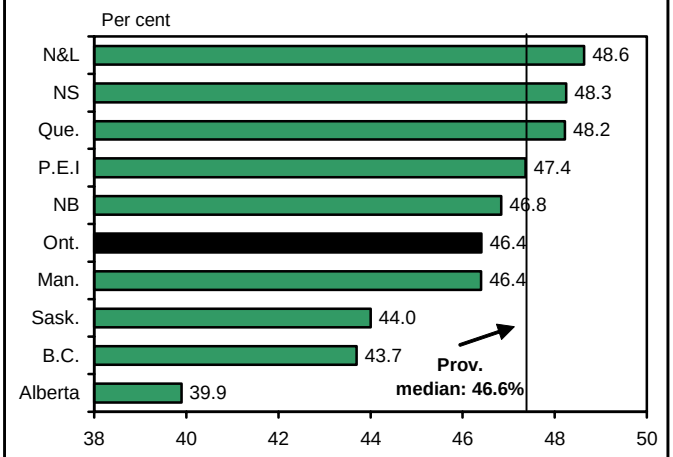
There are two truisms involved in how the federal government's redistributive role impacts Ontario. First, the federal government has to transfer less to the relatively wealthy Ontario than to other provinces. Second, if provinces are to have balanced budgets, then any shortfall in federal transfers relative to what other provinces receive

**CHART 19. CORPORATE INCOME TAX RATE ON JULY 1, 2006**




Source: 2006 provincial budgets

**CHART 20. COMBINED FEDERAL AND PROVINCIAL TOP PERSONAL INCOME TAX RATE**




Source: 2006 provincial budgets

**Ontario still subsidizes electricity rates**

Historically, Ontario has heavily subsidized electricity consumption. The $26 billion in debt accumulated of Ontario Hydro until it was broken up into its five successor companies in 1999 provides clear evidence that prices charged to consumers and businesses only partly covered the cost of providing the services in recent decades. While the size of the subsidy has declined in recent years, it it still the case that the Ontario government continues to subsidize electricity consumption. We estimate the overall subsidy is likely to be around $2 billion in 2006, down from $3.3 billion in 2005.

First, electricity consumption for residences and small businesses is subject to a two-tiered retail pricing scheme. Between April 1st 2005 and October 31th 2005, the rate was 5.0 cents per kilowatt-hour for the first 750 kilowatt-hour of electricity consumed and 5.8 cents above. The threshold was increased to 1,000 kilowatt-hour during the winter season, beginning in November. On May 1st 2006 the Ontario Energy Board set higher prices and lowered the summer season threshold. The rate moved up to 5.8 cents per kilowatt-hour for the first 600 kilowatt-hour and 6.7 cents above during the summer season. The threshold will be bumped up again to 1,000 kilowatt-hour during the winter season. Despite this price increase, the consumer continues to pay less than the cost. By assuming that the 2006 average weighted wholesale price – i.e. the price paid to suppliers – will be identical to 2005 (7.21 cents per kilowatt-hour), this translates into a subsidy of about $1 billion.

The government also subsidizes electricity for large users, which represents about one-third of the Ontario electricity market. In February 2006, the Ontario government decided to extend the electricity subsidy program for large power users until April 30th 2009. This extension will allow large users like manufacturers to save on their electricity bills by paying a capped price of 4.6 cents per kilowatt-hour – effective May 1st 2006 – rather than the wholesale price. In 2005, large users saved about $1.2 billion. Given that this program was extended to firms in the forestry sector – which are having a difficult time coping with higher energy costs and the stronger loonie at the same time – the amount saved this year could be potentially higher. Altogether, we estimate the subsidy for electricity to all Ontario's consumers is likely to come in around $2 billion this year.

must be exactly offset by an excess relative to other provinces in the difference between own-source revenues and total spending. If Ontario has difficulty raising more revenues on a per capita basis than other provinces because of its lack of royalties, then it must, short of running large deficits, spend less per capita than other provinces. Hence, the comparability between Ontario's shortfall of federal transfers of $1,235 per capita and its shortfall in total spending per capita of $1,109.

We have analyzed two ways in which Ontario is directly impacted by the redistributive role the federal government plays. First, the federal government's net fiscal take from Ontarians amounted to a 3.7-per-cent drag on Ontario's GDP in 2003, the latest year of actual data. Second, with competitiveness limits on how high it can run its own-source revenue collections, the shortfall in federal transfers to Ontario means the provincial government must spend considerably less per capita than other provinces. In 2003, that amounted to lower spending of $1,109 per capita relative to the all-province median.

There can be no single answer to how much redistribution the Ontario economy and its taxpayers can afford to finance. All one can say is that is the current economic environment of great competitiveness both within Canada and especially against the United States and other countries there is a limit and that limit must be considerably lower than in the past. Yet any enrichment of equalization would likely increase the net burden on Ontario. Premier McGuinty is calling for reforms to programs like immigration settlement, employment insurance and labour force training where Ontario receives less than its per capita share and higher federal transfers to be distributed on a per capita basis. Yet with the exception of eliminating the "associated equalization" component, higher per capita transfers cannot represent a long-term solution for Ontario. Higher federal spending will tend to keep federal revenues up and Ontario taxpayers contribute about 43 per cent of federal government collections while only receiving its population share or 39 per cent of the benefits at best. It amounts to getting 90.6 cents back on the dollar. Not a very good deal. The Ontario government should be seeking limits on the use of the federal government's spending power because Ontario taxpayers disproportionately pay the bill. If the federal government were so inclined, tax point transfers (unequalized) would be in Ontario's better interest. Finally, in the debate about changes to equalization, care-

ful thought must be given to how much redistribution within Canada can be financed by an open economy like Ontario's in a highly competitive world.

### Will the lights come on and at what price?

Ontario producers are quite rightly being weaned off heavily-subsidized electricity prices (See box on page 11). But at the same time as absorbing more of the total cost, they are legitimately worried that future supplies will be inadequate to prevent prices from being exorbitant. About 80 per cent (25,000 megawatts) of Ontario's current sources of electricity generation will be out of commission by 2020 and likely sooner. In addition, the Ontario government has issued warnings that if current trends prevail, underlying demand for electricity will outstrip supply in the province as early as 2007.

Given looming power shortages, the Ontario government set a goal of reducing by 5 per cent the projected peak of electricity demand by 2007. But massive investment will still be needed to guarantee adequate supply over the long haul. According to the 2006 Ontario Budget, the provincial government has advanced 33 electricity supply projects with about 11,000 megawatts of supply over the next five years. That is well short of the 25,000 megawatts that will be disappear over the next 15 years.

The new capacity will at best just offset the power loss from the promised closure of the province's coal-fired plants. As of today, only the Mississauga's Lakeview coal-fired electricity generators have been shut down. And given the fact that coal-fired plants represent about one-quarter of Ontario's total generation capacity, the provincial government has softened its position in respect to the timing of these closures. Finally, 20 years after the Chernobyl nuclear explosion, a debate is just beginning here on the future of nuclear plants and decisions are likely years away.

There is more to the story than just the upcoming squeeze in electricity generation. Indeed, Ontario also faces a potential shortfall on the transmission grid, which ultimately limits the capability to service end users. With about one-quarter of transmission stations reaching or exceeding capacity by 2013, massive investments will be needed on that front sooner than later (see TD Economics' special report entitled "Electricity In Canada – Who Needs It? Who's Got It?", March 7, 2005 for more details).

With the threat of provincial supply shortages, securing an east-west grid running from Lower Churchill in Labrador to Manitoba, needs to kick into high gear. Notably, we stated in our special report entitled "Lower Churchill River Hydroelectricity Development: The Project's Day in the Sun May Have Finally Arrived" that the probability of this hydroelectric project going ahead has never been brighter than today, that economic benefits are substantial, and that it has the potential to lower greenhouse gas emissions.

### The competitive threat from South-East Asia

Ontario's trade balance in goods with foreign countries deteriorated 3.0 percentage points of Ontario's GDP from 1996 to 2005. Two-thirds of the deterioration occurred against China and in turn, two-thirds of that was in manufacturing with the concentration in the category deemed capital intensive (Chart 21). Ontario's imports from China went from 0.7 to 2.8 per cent of provincial GDP during that period. Further, while the imports were initially principally low value-added items such as budget clothing and simple toys, the South-East Asian region has quickly been moving up the value-added chain with its exports (Chart 22). For example, five years ago China was a non-entity in the North American auto parts industry. Now 5 per cent of North American auto parts come from there. Ontario is not alone in experiencing a wave of imports from emerging economies. Since 1997 the share of Canadian imports from non-OECD countries has soared from 8 to 14 per cent (Chart 23).

Developed economies have felt the threat from new lower-cost competitors before. So there is a substantial body of literature of what should transpire and many case studies on what has happened. We will briefly examine each perspective.

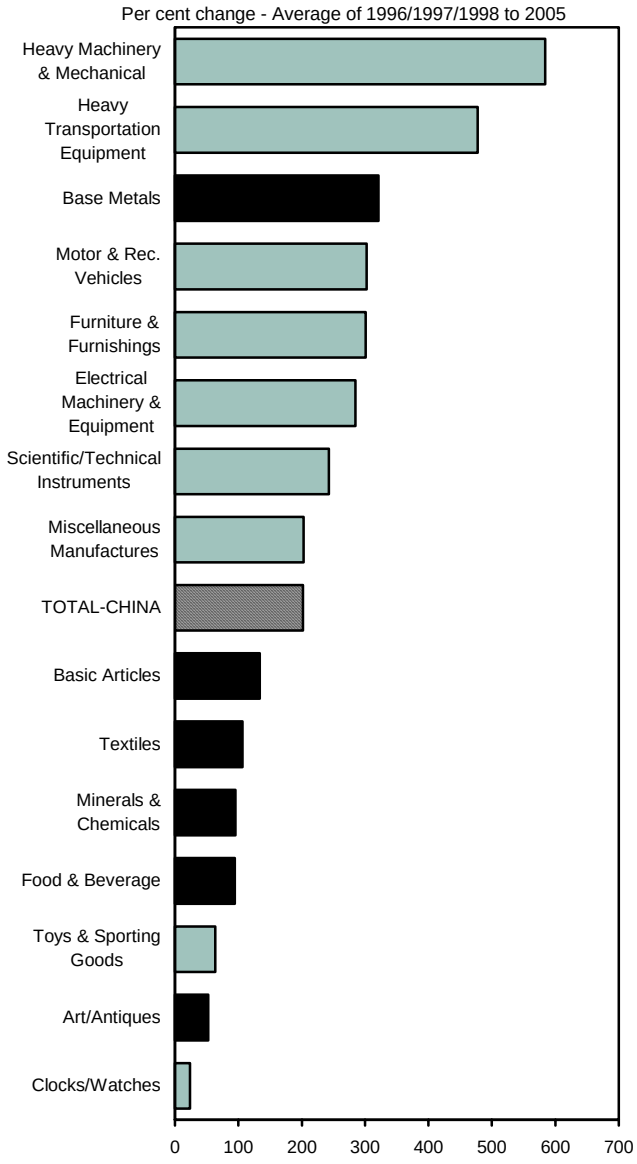
Economic theory and historical experience show that trade liberalization strengthens the economies of poorer

**CHART 21. ONTARIO'S TRADE BALANCE IN GOODS**
**IN PERCENT 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

**CHART 22. CANADIAN IMPORTS FROM CHINA***



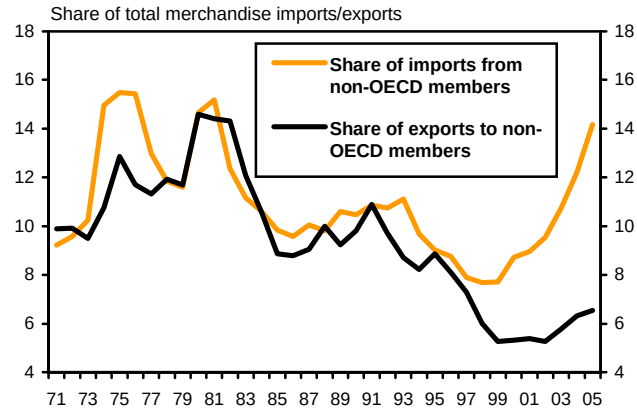

*Light bars are manufacturing sectors while dark bars are other sectors; Source: Statistics Canada

countries. Between 1980 and 2000, real per capita incomes rose 440 per cent in China and doubled in India relative to a 60 per cent gain in the United States. In the book Why Globalization Works, economist Martin Wolf summarizes some more general findings for poorer countries that opened their doors to freer trade:

- All countries that have risen in the ranks of global living standards were more open to trade and capital in the 1990s than in the 1960s;
- Between 1960 and 2000 a typical country that switched from a closed to an open economy raised its real per capita GDP growth rate by 1.4 percentage points per year;
- Multi-national corporations in developing countries tend to pay substantially above local wages. For example, in Indonesia, foreign-owned firms pay 33 per cent more for blue-collar workers and 70 per cent more for white-collar workers than locally-owned firms. Likewise, Vietnamese workers in apparel and footwear factories rank in the top 20 per cent of the local population by household expenditures;
- The share of the world population living on $2 per day has fallen from 44 per cent in 1970 to 19 per cent in 1998 (1993 Purchasing Power Parity terms).

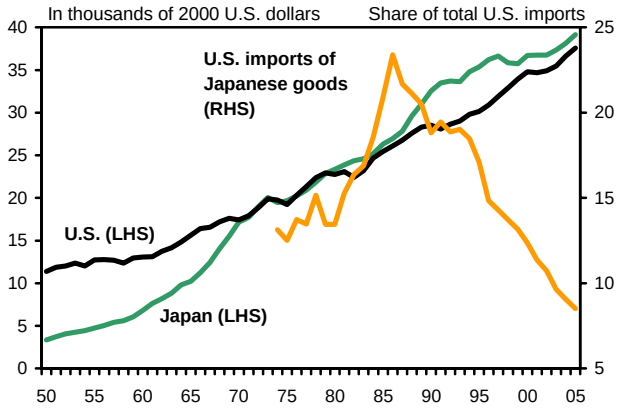
Theory and experience also suggest that developed economies respond to trade liberalization by shifting from goods production into services and within goods, moving further up the value-added chain and into niches where their productivity advantage is greatest. In turn, demand for the goods and services from the developed economies is bolstered by the rising incomes in the poorer countries. Taking a long term perspective, we note that in 1913, goods accounted for two-thirds of production in advanced economies whereas today two-thirds is services. Over the past few centuries the United Kingdom has faced numerous competitive threats from former colonies, the rise of the U.S. economic empire being perhaps the most notable. Yet, in turn, the U.K. economy is still one of the wealthiest in the world. The United States has faced a competitive

**CHART 23. ORIGIN OF CANADIAN GOODS TRADE**




Source: Statistics Canada

**CHART 24. REAL GDP PER CAPITA IN THE UNITED STATES AND JAPAN**




Source: Penn World Tables version 6.1 and national authorities

threat from Japan in recent decades. In 1950, real per capita incomes in Japan were only 29 per cent of those in the United States and Japan exported little of its merchandise to the U.S. By 1986, real per capita incomes in Japan had risen to 103 per cent of the U.S. level and Japanese merchandise exports to the U.S. stood at 23 per cent of all U.S. imports (Chart 24). The world was toasting Japan's economic miracle by the end of the 1980s and there was rampant speculation that Japan would take over from the U.S. in economic supremacy as the American manufacturing sector - perhaps best exemplified by its automobile industry - was not thought up to the Japanese test. The Japanese car companies are still gaining North American market share at the expense of the Big 3 North American car companies, but the tide turned on the fates of the two economies in total. Since 1992, real GDP per capita has only grown at an average annual pace of 1.1 per cent in Japan versus 2.1 per cent in the United States.

From a North American perspective perhaps the most memorable aspect of the Japanese growth surge post WWII is the penetration of its exports into our economies. Japanese exports did record average annual growth of 13 per cent from 1956 to 1980 while the average was about half that at 7 per cent for other OECD countries. But the focus on exports misses the critical importance capital accumulation played in the Japanese growth story. Japanese capital spending rose 9 per cent per year from 1950 to 1973, buoyed by the high domestic savings facilitated by demilitarization and the need for personal savings given the limited social safety net. There was also the need to replace the 40 per cent of Japan's capital stock destroyed during the war. Much of that investment, along with surging imports of technology, went into strengthening the manufacturing sector where output expanded at an annual growth rate of 14 per cent from 1953 to 1971. Together with a highly educated labour force, the focus on capital accumulation proved a powerful recipe for surging productivity growth.

Investment has been the catalyst behind many economic success stories. But ultimately productivity must kick in to sustain that growth. The timing of the shift from investment to productivity has varied. For the initial 20-30 years of growth for the Asian tigers and for much of the Soviet-era expansion, input growth - capital and labour accumulation through forces such as migration to urban areas - investment led the way without large productivity gains. For example, between 1966 and 1990, real GDP grew at an annual pace of 8.5 per cent in Singapore and investment soared as a share of output from 11 to 40 per cent. Productivity picked up once the capital was in place and the population better educated. Korea, on the other hand, introduced incentives to accumulate technological innovation and saw productivity gains more contemporaneously with the investment surge.

In an analysis of long-term performance of the U.S. economy, Robert Solow estimated that 80 per cent of the increase in U.S. per capita income was the result of productivity gains while the remaining 20 per cent came from capital investment. Investment has certainly played a key role in recent U.S. growth and is an explanatory factor for the superior American productivity over the Canadian experience. Investment explains much of the U.S. success story on productivity as well. Indeed, the Centre for the Study of Living Standards estimates that the U.S.'s higher capital intensity explains one-quarter of the Canada-U.S. productivity gap. Since 2001 for every dollar per employee spent on machinery, equipment, land and structure in the United States, only 85 cents has been spent in Canada. Further, a larger proportion of the Canadian capital stock is in structures whereas productivity growth comes more from machinery and equipment. The ratio of machinery and equipment to hours worked in Canada has only been about 55 per cent of that in the United States.

While theory and experience suggest that advanced economies can continue to prosper over time even as poorer countries make important economic gains, the process is

not always smooth. The United Kingdom has certainly seen some extended periods of economic gloom and the U.S. economy also faced some struggles through the 1970s and 1980s, in part due to increased Japanese competition. Ontario and Canada have certainly not yet seen the lifting effect to their exports from the wealth being created in the emerging economies. While non-OECD imports of goods rose from 8 to 14 per cent of Canada's total imports over the 1996-2005 period, exports to the non-OECD countries continued to fall despite the commodity price boom. The result has been a deterioration in the trade balance with non-OECD countries of 7.6 per cent of Canada's GDP.

Improvements in information technology and capital flows are accelerating the gains in the developing economies in terms of both ramping up their production and in moving that production up the value-added ladder. This could make it even harder in the future for the advanced economies to maintain their edge and it raises some question about the applicability of past experiences. In particular, there is now rampant concern that globalization will represent a longer-term challenge to the industrial base of economies like Ontario's. Could the rise of the southeast Asian economies be the challenge that hollows out Ontario's industrial base or at least makes it sustainable only once wages have been driven way down?

The concern for the industrial base of Ontario is particularly acute where lower-skilled labour is involved. There is an abundance of low-skilled labour in the world and much of it is located in China and India where 20 per cent of the world's population resides. There is some casual evidence that this competition is influencing Canadian wages as we witnessed a substantial widening of pay in Canada along skill and trade lines in the past decade. Retail sales, protective services and manufacturing/utilities wages have declined 4 per cent in real terms. The largest real wage gains have been in services where there is greater insulation from trade. Childcare and home support wages are up 23 per cent (albeit from low relative levels). Wages for high-skilled services workers have also risen appreciably. Management, business and finance wages are up 12 to 16 per cent in the past decade while administrative pay has risen 10 per cent and science-related professions have seen their pay rise 4.6 per cent in real terms (Chart 25). Canada is not alone in experiencing trade-related divergences in pay increases. In the United States, 15 to 33 per cent of income inequality between skilled and less-skilled labour in recent decades is directly associated with competitive forces from trade (as cited in Wolf from Lindert and Williamson, Does Globalization Make the World More Unequal).

The historical record of international competition clearly shows that while freer trade brings overall benefits to both sides of the transaction, there are often difficult transitional costs that tend to fall disproportionately on a narrow segment of the population. According to OECD studies of job churning (summarized in Trade and Structural Adjustment: Embracing Globalization, OECD 2005), typically 3 to 5 per cent of the workforce in OECD countries experience an involuntary layoff in any given year (the U.S. and Canada are at the high end at 5 per cent) with about one-third of these displacements corresponding to firm closing and other mass layoffs. The OECD found that involuntary displacement of workers is

**CHART 25. CANADIAN CUMULATIVE WAGE INCREASES, JANUARY 1997-MARCH 2006**

| | Nominal | Real |
|---|---|---|
| Childcare and home support workers | 49 | 23 |
| Management occupations | 40 | 16 |
| Professional occupations in business and finance | 35 | 12 |
| Financial, secretarial and administrative occupations | 32 | 9 |
| Natural and applied sciences and related occupations | 28 | 6 |
| Occupations in social science, government service and religion | 26 | 4 |
| Chefs, cooks, and occupations in food and beverage service | 25 | 4 |
| Clerical occupations, including supervisors | 25 | 4 |
| **Total employees, all occupations** | **24** | **2** |
| Health occupations | 22 | 1 |
| Sales and service occupations | 22 | 1 |
| Construction trades | 21 | 0 |
| Teachers and professors | 20 | 0 |
| Trades, transport and equipment operators and related occupations | 20 | 0 |
| Transport and equipment operators | 20 | -1 |
| Other trades occupations | 19 | -1 |
| Occupations unique to primary industry | 19 | -2 |
| Contractors and supervisors in trades and transportation | 17 | -3 |
| Occupations unique to processing, manufacturing and utilities | 16 | -4 |
| Occupation in protective services | 16 | -4 |
| Retail salespersons, sales clerks, cashiers, and supervisors | 16 | -4 |

Source: Statistics Canada

often associated with long spells of unemployment or recourse to early retirement or disability benefits, especially for high-tenure workers displaced from declining manufacturing industries. Re-employed workers often experience a significant and persistent loss in earnings compared to their previous employment, particularly if they must change industry and cannot capitalize on accumulated sector-specific skills. For example, two-thirds of re-employed U.S. workers who lost their jobs due to import competition earned less in their new jobs that they did in their previous one and one-quarter experienced earnings losses in excess of 30 per cent.

### The Answer to the Challenges: Its Mostly About Productivity

An economy can only sustain high wages if it has strong productivity. Advanced economies like Ontario have had a tremendous edge on productivity over the emerging competitors. For example, the American economist Stephen Glub found that Malaysian, Filipino, Indian and Thai manufacturing productivity was only 15 per cent the American level in 1990 and so too were wages. Indeed their unit labour costs exceeded the U.S. level. Between 1995 and 1999, a U.S. manufacturing worker was paid an annual salary of $29,000, but that person contributed value added of $81,000. A Chinese manufacturing worker was paid an annual salary of $730, but contributed value added of only $2,900 (Martin Wolf). In short, labour was cheap because it was unproductive.

Productivity has been improving rapidly in emerging economies and will continue to do so. Therefore, the past productivity edge of advanced economies cannot be taken for granted (Chart 26). Productivity in the South and South East Asian region is growing 6 times faster than in Canada and many other western countries. For example, productivity in Chinese manufacturing has doubled over the past decade. This has been reflected in a doubling of their real wages whereas productivity and real wages in Canada have been fairly flat.

We will in a moment outline some of the areas where Ontario could act to improve its dismal productivity record. But, before getting to that we will examine an interesting case study demonstrating the importance of bolstering investment in capital in order to support a vulnerable industry through the competitiveness challenge.

The U.S. textile industry of the early 1970s would have to be considered prime fodder for extinction due to the competition from emerging economies. Yet the yarn and fabric portion has survived, albeit with a loss of 20 per cent of its employment base. The reason was that 4 per cent of shipment value from 1972 to 1992 was ploughed into new technology. Reinvestment was also supported by programs such as accelerated tax depreciation on capital. In contrast, clothing manufacturers only ploughed 1.5 per cent of their shipment value back into investment and with a generally lower level of capital intensity half of its employment base was lost. In total, textile industry productivity rose three fold over the past 50 years compared to a doubling for all U.S. manufacturing. There was also a process of moving into profitable niche segments.

In the Canadian textile industry domestic shipments are being squeezed out by imports which accounted for 64 per cent of the Canadian market in 2005 compared to 38 per cent in 1990. But the industry has responded by seeking new export markets. Since 1990, exports have risen

**CHART 26. CUMULATIVE PRODUCTIVITY (OUTPUT PER EMPLOYED PERSON) GAINS IN SELECTED COUNTRIES: 1997-2005**

| | Per cent |
|---|---|
| Korea | 81 |
| China | 67* |
| India | 46** |
| Greece | 23*** |
| Ireland | 21*** |
| United States | 17 |
| Sweden | 16 |
| Finland | 15 |
| United Kingdom | 15 |
| Denmark | 14 |
| **Ontario** | **14** |
| Norway | 13 |
| Austria | 13 |
| Japan | 12 |
| Australia | 12 |
| Canada | 11 |
| New Zealand | 10 |
| Luxembourg | 9 |
| Belgium | 9 |
| France | 9 |
| Germany | 7 |
| Switzerland | 7 |
| Netherlands | 5 |
| Italy | 4 |
| Portugal | -1 |
| Spain | -6 |

*1997-2004; **1997-2003; ***1998-2005

Source: National authorities

**CHART 27. JOB CHURNING: REALLOCATION OF MARKET SHARE IN CANADIAN MANUFACTURING: 1988-1997**

| | Per cent of market |
|---|---|
| Market share transferred | 37 |
| Market gain from continuing plants | 16 |
| Market gain from new plants | 21 |
| Market loss from continuing plants | 21 |
| Market loss from closing plants | 16 |

Source: Statistics Canada

from 21 to 48 per cent of domestic production. Still, textile production has declined since its peak in 2000 (its employment peak occurred in 2001). The number of establishments has declined by 12 per cent since 2000 (through consolidations and bankruptcies) and employment has declined by 9,000 or 17 per cent since 2001.

Studies by Statistics Canada highlight the dynamic process of productivity gains in Canadian manufacturing. The simplest notion of productivity growth is that established firms and workers find better ways of doing business. But Statistics Canada found that from 1973 to 1997 this source contributed less than half of overall productivity gains. The main source of productivity growth was the competitive process that shifts market share toward plants – either existing or new – that are more productive. The pace of market-share reallocation increased in the 1990s as manufacturers responded to the Free Trade Agreement and then the North American Free Trade Agreement. Between 1988 and 1997, 37 per cent of market share in a manufacturing industry was transferred from plants that either contracted or closed, to new plants or plants that expanded (Chart 27).

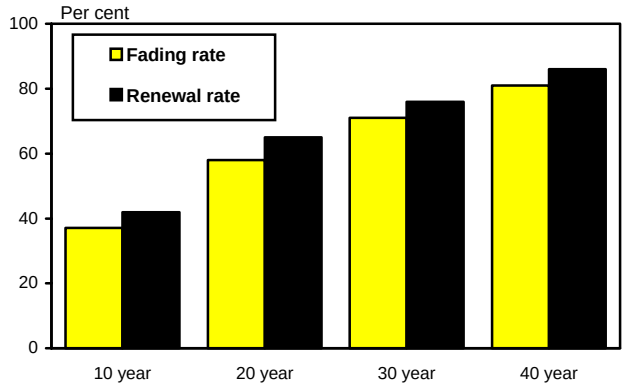
Employment in manufacturing is just as dynamic as output. Between 1973 and 1996 employment in Canadian manufacturing was little changed, having risen 2 per cent from 1.66 million to 1.70 million. Yet over 1 million factory jobs that existed in 1973 had been eliminated by 1996 and had been replaced by new jobs. Fifty-five per cent of the jobs in 1996 that had not existed in 1973 were created by new businesses. Jobs created in new plants built by incumbent firms accounted for about 19 per cent of these jobs while new employment from expanding existing plants represented about one out of every four new jobs. Over a decade, two out of every five jobs in manufacturing are eliminated because of plant closures or downsizing and replaced by new jobs (Chart 28). Looking across subcategories of manufacturing, Statistics Canada found that a lack of investment in new establishments differentiated the more dynamic industries from the declining ones.

Ramping up Ontario's productivity may not be sufficient to prevent some rocky times for the province's economy. But we know it is a necessary condition to have a shot at continued prosperity. Wages will rise in the emerging economies and that will ease some of the current pressure. But Asian wages won't rise to Ontario standards by 2020. If we want to maintain our superior pay and benefits, we must produce superior productivity levels. Nothing short of a complete turn-around from Ontario's dismal productivity record of the past 20 years is required (chart 29).

TD Economics recently released a paper summarizing the main ingredients of a productivity agenda for Canada (TD Economics, 3 Stars of the 2006 Federal Budget, May 23, 2006). Most of the factors are relevant for Ontario We will only summarize the national factors here and add in the Ontario-specific requirements.

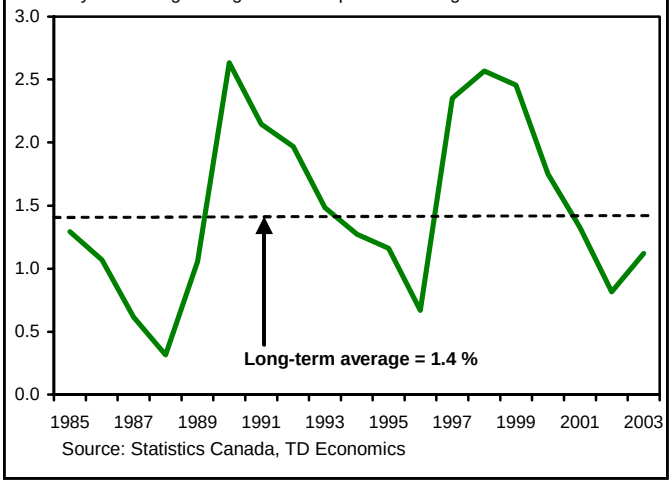
Before doing so, we will set the context from what can be learned from historical experience. Countries that have recorded growth surges that have taken them to sustained, higher standards of living have relied heavily on surging investment. Countries that have successfully fended off rising competitive threats from emerging economies and taken their own standard of living to new levels succeeded because they recorded strong productivity performances. That in turn depended upon heavy investment (both physical and human capital). New technology plays a key role, but it does not necessarily have to be developed in the

**CHART 28. JOB FADING AND RENEWAL RATES IN CANADIAN MANUFACTURING**




Note: The chart shows that after 10 years, just under 40 per cent of jobs were eliminated because of plant closures/downsizing and, in turn, more than 40 per cent of the jobs were created in that decade; Source: Statistics Canada

**CHART 29. ONTARIO'S LABOUR PRODUCTIVITY**




host country. Importing best practices from abroad is often more effective. Perhaps the most telling lesson from the past is that advanced economies that improve their productivity are characterized by constant change. Markets shift to expanding and new firms while other establishments whither or fail. Workers go where the new production is. Change can be uncomfortable. It forces transitional difficulties particularly upon a sub-set of the population that tends to be less educated and skilled. As dislocation is difficult on people it is often resisted by governments. Success stories tend to show a balance being struck between fostering change while providing support for those adversely affected.

We start with 3 policy needs that are specific to the Ontario situation that absolutely must be rectified for the Ontario economy to thrive in 2020. Then we move to some more general issues that are holding back Ontario's productivity.

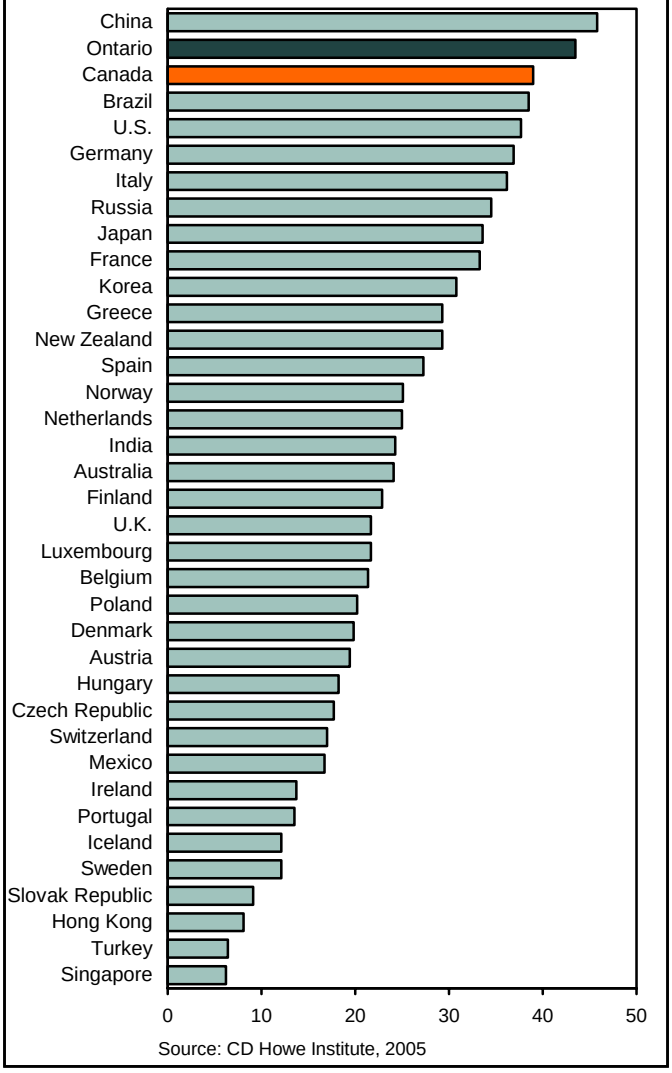
1. Move with greater haste to reduce congestion to and across the main Ontario-U.S. border crossings.

2. Move with greater haste to expand electricity generation capacity in Ontario with an east-west corridor grid, while continuing to move to market pricing.

3. Work with the federal government to limit the federal fiscal drag on the Ontario economy.

4. Reduce Ontario's extremely high rates of taxation on capital (second highest in Canada after Saskatchewan

**CHART 30. MARGINAL EFFECTIVE TAX RATE ON CAPITAL**




and higher than in any of the 35 countries recently studied by the C.D. Howe Institute other than China (Chart 30). This comes from high commercial and industrial property taxes, a high corporate income tax rate, a high capital tax rate and application of the provincial sales tax rate to capital.

5. Reduce the high effective marginal income tax rates that dull the incentives to work, save and invest. The marginal tax rate for high income earners in the province is 46.4 per cent, but counting the loss of federal and social benefits as income rises, the effective marginal rates for lower-income Ontario families can exceed 60 per cent and in the case of those exiting welfare, 100 per cent or even more if the loss of inkind

benefits to welfare recipients is counted.

6. Invest in education and infrastructure, as has been done in recent Ontario budgets.

7. Maintain budget balances so the provincial debt burden will decline and the lower taxes and expenditure reallocations can be sustained. Balancing the budget while lowering taxes and raising investments will require extreme parsimony on many of the "consumption" elements of provincial spending.

8. Work with the federal government to improve the economic benefits to the province from immigration. This goes beyond the recent focus on improving credential recognition and settlement services and would include more pro-active marketing to potential immigrants best fitting the profiles of skill shortages in the province.

9. Ontario businesses need to increase their investment, particularly in research and development, technology developed elsewhere, and machinery and equipment and more companies need to seek export opportunities.

10. Companies and individuals in Ontario need to devote more time and money to lifelong learning and training.

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