Ontario Prosperity Initiative

Can Canada Prosper Without A Prosperous Ontario?

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Summary

Ontario's economic struggles, which are most dramatically illustrated by its transition to a "have-not" province, have implications far beyond the borders of the province. For the better part of a decade, and particularly since the recession of 2008/09, Ontario's economic performance has dragged down that of the national economy. Due to both the sheer size of Ontario's economy and its population, as well as the fact that the Canadian economy is highly integrated, what happens in Ontario influences our national economy.

The important influence of Ontario on the national economy is borne out by statistics. For example, if we compare the variation in per-capita GDP growth for Canada (without Ontario) against the variation in Ontario for the period from 1982 to 2012, we find that the variation in Ontario explains roughly three quarters of the variation in the rest of the national economy. Simply put, for the better part of three decades, the success of Canada's economy was inextricably linked with the success and failure of Ontario's economy.

Ontario's influence is also seen in employment statistics. About two thirds of the variation in employment growth in the rest of Canada between 1982 and 2012 is explained by the variation in employment growth in Ontario. In other words, Canada experienced strong employment growth when Ontario experienced strong employment growth, and vice versa.

Unfortunately, Ontario's under-performance since the early 2000s—and particularly since the recession of 2008/09—has been dragging down our national performance. Across a whole host of economic indicators, Ontario is simply not performing at the national average, let alone filling its traditional role as a foundation for the national economy. From 1981 to 2004, Ontario's real per-capita GDP (a broad measure of income) was either above or equal to the rest of Canada. A slow-down in per-capita GDP growth began in Ontario after 2000 and, starting in 2005, Ontario's real per-capita GDP fell below that of the rest of Canada. In 2004, Ontario's real per-capita GDP was 0.36% higher than the rest of Canada. By 2012, Ontario's real per-capita GDP was 5.6% lower than the rest of Canada. Indeed, in 2012, if data for Ontario were excluded, Canada's per-capita GDP would be 2.2% higher.

Since 2000, Ontario has recorded the third lowest rate of private sector job creation in the country, ahead of only Nova Scotia and New Brunswick. Specifically, Ontario's private sector employment growth between 2000 and 2013 totaled 14.1% compared to first-placed Alberta's 42.1% or to Canada as a whole, which recorded 19.0% growth.

Not surprisingly, Ontario's performance in keeping unemployment rates low is poor, particularly after the 2008/09 recession. Specifically, Ontario ranked fifth among Canadian provinces over the period from 2000 to 2013 for

its unemployment rate, which averaged 7.1%. This was generally in line with the Canadian average for the period. However, Ontario falls one position to sixth and maintains a higher-than-average unemployment rate when the post-recession period is examined.

Another way to think about Ontario's higher than average unemployment rate is to consider what the national rate would be if Ontario were excluded. The national unemployment rate for the period from 2009 to 2013 was 7.6%. It declines to 7.3% if Ontario is excluded.

Another measure indicative of the economic problems in Ontario is business investment or what is technically referred to as gross fixed capital formation, which measures the value of new additions to productive assets such as buildings, machinery, and equipment. It is important because it represents an addition to the economy's productive capacity as well as the employment of new technology. In 1990, Ontario's share of Canadian capital formation closely matched its share of the population. Its current share of the national capital formation is 31%, well below its population share. This decline in productive investment suggests that in the future there will be growing economic productivity problems.

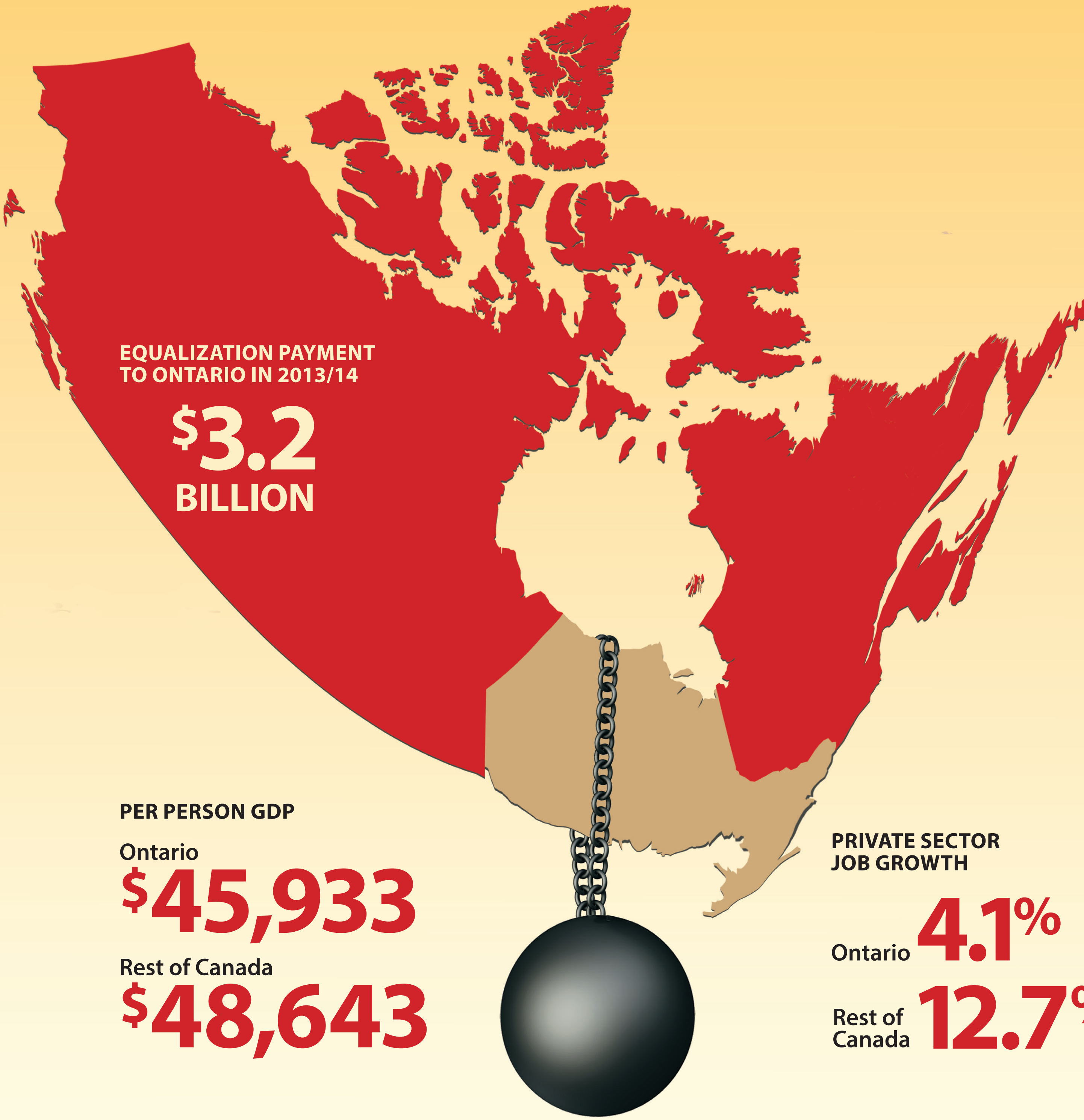
Ontario's poor record on GDP growth, employment gains, and unemployment have meant a poorer national performance than would otherwise be the case. Simply put, an economically stronger Ontario means an economically stronger Canada. Canada outside of Ontario has seen decent rates of economic growth in per-capita GDP and employment but, when Ontario is factored into national statistics, Canada's economic performance is brought down. As much as Canada boasts of weathering the post-recession period in reasonably good economic shape compared to other G-7 countries, it could have performed even better with a more buoyant and productive Ontario. There is a difference between being mediocre and being excellent.

Ontario's economic weakness also translates into weak financial performance by the government of Ontario. For instance, in 2012/13, Ontario accounted for 49.6% of all provincial net government debt in Canada, reflecting a debt much larger than its population share. Indeed, in 2012/13, Ontario reported the highest provincial net public debt of all the provinces, and the second highest net debt level as a share of the economy (GDP) of the provinces.

Ontario's failure to come to grips with its economic productivity and growth issues has serious implications for itself as well as the future growth of the Canadian economy. Even given the impressive performance of regional resource-driven economies outside Ontario and increasing international and North American integration of Canada's economic regions, there is still a high correlation between Ontario's economic performance and the rest of Canada. The end result is that Canada's economic performance remains tied to Ontario's economic performance. Canada can get by without Ontario doing well but could prosper even more if Ontario overcame its economic disrepair and began firing on all cylinders. Ontario is a vast pool of human, physical and financial capital that is not living up to its potential.

Ontario can do better. Smarter policies focused on competitiveness and encouraging economic growth rather than interventionist industrial policies and expansionary government are the solutions to Ontario's lagging performance. Specifically, improved tax and regulatory competitiveness coupled with better energy and industrial policies would establish the foundation for improved economic performance in Ontario. It can start by getting its public finances in order, boosting its economic productivity, recognizing that government economic intervention has its limits, and unleash its private sector on its northern resource frontier.

Ontario's Drag on the Canadian Economy



PER PERSON GDP

Ontario
$45,933

Rest of Canada
$48,643

PRIVATE SECTOR JOB GROWTH

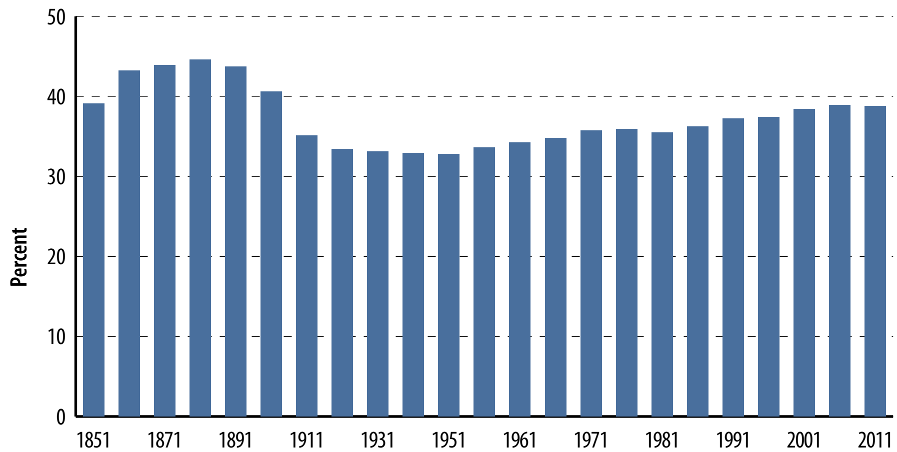
Ontario **4.1%**

Rest of Canada **12.7%**

Introduction

Ontario has been a keystone of the Canadian economy since Confederation.[1] Ontario is the Canadian province with the largest population and greatest economic output and contains Toronto, Canada's largest urban and financial centre. Since the mid-nineteenth century, Ontario's share of the national population has ranged from a high of 44.6% in 1881 to a low of 32.8% in 1951 (**figure 1**).[2] Since 1951, Ontario's share of Canada's population has grown steadily and by 2011 stood at 38.8%.[3] However, this increasing share of the population is now being accompanied by a declining share of Canada's GDP.

Figure 1: Ontario's Share of Canada's Population, 1851–2011

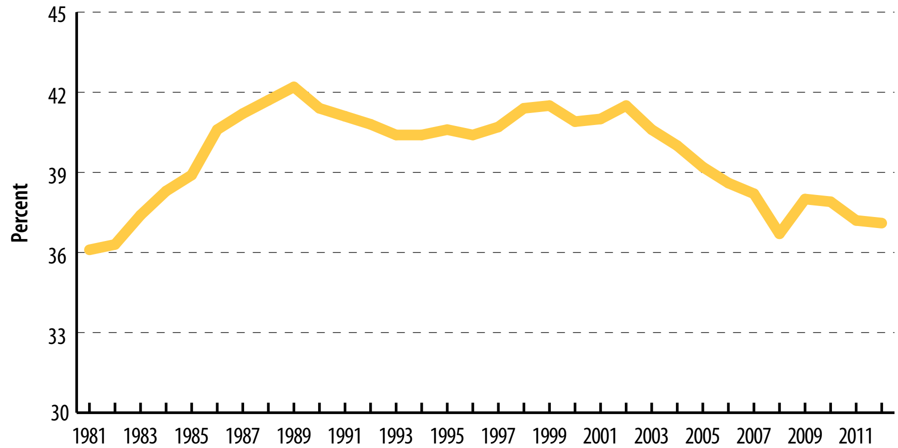


Sources: 1851–1976—Leacy (1983): tables A2–A14; 1981–2011—Statistics Canada, CANSIM table 051-0001; calculations by authors.

In the wake of the 1981 recession, Ontario's share of Canada's GDP was 36.1%, but the province recovered and its share of GDP peaked at 42.2% in 1989 (**figure 2**). Since 1989, Ontario's share of Canada's GDP has declined, and by 2012 had fallen to 37.1%. The decline occurred in two phases: a decline with a partial recovery over the period from 1989 to 2002 and then a more rapid drop since 2002. A rising share of Canada's population combined with a declining share of its output does not bode well for either the Ontario or Canadian economies. Ontario still accounts for a large proportion of Canada's economy and the economic performance of the rest of the country is still correlated with Ontario's.

1. As Baskerville writes: "From the start, Ontario was the strongest province in the new nation. Almost half of Canadians lived there" (2002: 125).
2. Leacy (1983): series A1–A14.
3. 1851–1976—Leacy (1983): table A2–A14; 1981–2011—Statistics Canada, CANSIM Table 051-0001; calculations by authors.

Figure 2: Ontario's Share of Canadian Nominal GDP, 1981–2012



Sources: Statistics Canada, CANSIM table 384-0037; calculations by authors.

Ontario is caught in an economic malaise as the result of stalled adjustments to a changing economic world. Ontario—a province that in the 1960s had a real per-capita GDP that was one of the highest in Canada—is now mid-ranked, surpassed by Newfoundland & Labrador and Saskatchewan. It is also now considered a "have not" province under the Canadian equalization system.[4] At the same time, economic growth in Canada's resource-producing provinces has buoyed Canada's economy, leading to speculation that Canada can prosper generally without Ontario participating or supporting such prosperity.

Can Canada prosper without Ontario also prospering? There are a number of dimensions to consider as Canadians ponder this critically important issue. On the one hand, a less economically dominant Ontario could mean a more economically balanced Canadian economy. This is true, however, only if the reduced dominance of Ontario is the result of other provinces doing well rather than Ontario performing poorly. Given the sheer mass and importance of its economy, Ontario remains an important part of the Canadian economy and its dysfunction drags down the entire country's performance. In the long run, Canada can do better if Ontario does better.

Ontario's economic malaise—a brief economic history

After a late nineteenth century slump that saw substantial emigration, Ontario's economy grew rapidly during the twentieth century.[5] Ontario's economy was ignited during the early twentieth century by two booms that fuelled its manufacturing

4. For a discussion of how Ontario's change from a "have" to a "have-not" province has changed the nature of the equalization program, please see: Milke (2014b), <http://www.fraserinstitute.org/research-news/news/news-releases/Have-not-Ontario-radically-alters-Canada-s-equalization-program/>.
5. The period prior to 1900 was viewed as a period of stagnation by contemporaries and witnessed substantial migration by Canadians to the United States. The absolute numbers of Canadian-born residents of the United States grew from 147,711 in 1850 to 1,204,637 by 1910 as between 1850 and 1920 nearly two million Canadians emigrated to the United States. See Jackson (1923).

sector's growth and ensured that Toronto would eventually supplant Montreal to become the preeminent financial centre of Canada. The first was the Prairie settlement that saw hundreds of thousands of European settlers flock to the Prairies and form a market for consumer goods produced by central Canadian industry. The second was the forestry and mining resource boom of Ontario's northern frontier, which generated inputs into southern Ontario industry, and created Toronto's role as a financial centre as expertise was gained from financing new resource ventures. This created a lucrative source of provincial government revenue via enormous resource rents and royalties that helped fuel spending on infrastructure by the Ontario government in the late nineteenth and early twentieth centuries.[6]

Combined with the additional advantages of a cost-effective hydroelectric system, a robust market economy, and an advantageous proximity to the US market, Ontario's economy became Canada's economic powerhouse by the mid-twentieth century.[7] Twentieth-century Ontario reaped the economic benefits of the nineteenth century Canadian economic strategy of building an east-west economic corridor with Ontario at its centre. In return, transfers from Ontario such as equalization "were simply worthwhile investments in preserving a union that was, at the end, to Ontario's advantage".[8]

The economy after World War II saw change as gradual economic liberalization in international trade and growing North American economic integration, particularly in manufacturing, developed. Chief of these for Ontario was the Canada-United States Automotive Products Agreement ("Auto Pact"), which removed tariffs on motor vehicles as well as automotive parts between the two countries and helped grow Ontario's manufacturing sector. Ontario's economic development reached a crucial watershed in the wake of the economic boom of the 1980s that saw free trade with the United States, a shift away from the traditional east-west economic alignment, and the recession of the early 1990s. In essence, Ontario began a process of economic transition and adjustment to these developments that was accompanied by the political change brought about by the election of a government that was more market-oriented in its policies and willing to change Ontario's conception of itself to suit changing times.[9]

Faced with high public debt in the wake of the 1991 recession, high welfare rates, and a tax system that was viewed as uncompetitive, in the mid-1990s the Ontario government launched a series of economic and public-sector reforms designed to make Ontario more competitive in a changing international economy.[10]

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6. See Di Matteo (1999).

7. For excellent overviews of Ontario economic history, see Drummond (1987) and Rea (1985). For an account of Ontario history, see Baskerville (2002).

8. Ibbitson (2001): 189.

9. In 1995, the Conservative government of Premier Mike Harris replaced the New Democratic government of Premier Bob Rae.

10. These changes were broad based and involved an attempt at public-sector restructuring that included hospital consolidation, municipal amalgamation, shifting services to municipalities, consolidating school boards, property tax reform, and cuts to transfers to partners such as municipalities, schools, and

Indeed, the 1990s were a period of economic and policy reforms across the country. According to Tom Courchene: "Ontario effectively superseded the erstwhile conception of itself as the economic and focal point for a trans-Canadian east-west economy and turned its attention and its policy arsenal to take advantage of the emerging opportunities ushered in by the Canada-U.S. Free Trade Agreement and by NAFTA" (2004: 158). Indeed, the 1990s moved the province further along a road it had begun to travel in the 1960s with the onset of the Auto Pact.

Yet, notwithstanding the prosperity of the late 1990s, the adjustment was incomplete. The economic progress Ontario made during the 1990s was a function not only of a booming US economy and tax changes brought about by the Ontario government,[11] but also of low interest rates that propelled housing construction and a low Canadian dollar that allowed Ontario's manufacturing firms to compete. This had an impact on investment in new capital in manufacturing by encouraging investment in industries already benefitting from a low dollar[12] and would have consequences for the manufacturing sector's productivity once the dollar appreciated and energy costs rose, the rise in energy costs also partly the result of government policy.[13]

As well, despite the attempts at restructuring the public sector, full adjustment to the new economic era suffered a relapse with the change after 2000 to a government that opted for increased government spending and a more interventionist style in dealing with the economy.[14] The first decade of the 21st century saw tax increases and increases in public spending and then an industrial strategy based on a transition to green energy, a factor in the resulting higher cost for electricity.[15]

Ontario's current economic malaise is thus the outcome of an incomplete transition to a more competitive world economy and a serious long-term set of economic problems rooted in its economic productivity that were aggravated by

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universities. There was also reform of the electricity supply with the proposed deregulation and privatization of Ontario's electricity system. In the end, the electricity privatization was incomplete as Hydro One continued as a major electricity supplier with the Government of Ontario as its single shareholder.

11. For an account of the arrival of the Harris era, see Ibbitson (1997).

12. Capital expenditures in Ontario manufacturing nearly doubled between 1991 and 1999 and then began to decline. For the period from 1991 to 2000, new capital expenditures in Ontario manufacturing rose 52% but between 2001 and 2013 declined 36%. During the 1990s, some of the largest percentage increases in new capital spending were in professional, scientific, and technical services, furniture and related product manufacturing, wood product manufacturing, forestry and logging, and construction. The forest products sector in particular was especially sensitive to the value of the exchange rate given the importance of the US market for lumber and paper products. The period from 2000 to 2013 has seen the sharpest percentage declines in computer and electronic product manufacturing, furniture and related products, transportation equipment manufacturing, clothing, wood products, and paper manufacturing. Interestingly enough, some of the largest percentage increases in new capital expenditures for the period from 2000 to 2013 came in the areas of provincial public administration and waste and remediation services. (Authors' calculations and analysis from data source: Statistics Canada, CANSIM Table 029-0005).

13. For a discussion of government energy policy, see McKitrick (2013), <http://www.fraserinstitute.org/research-news/news/display.aspx?id=19538>.

14. Substantial spending increases began under Conservative premier Ernie Eves and were continued with the election of the Liberals under Premier Dalton McGuinty.

15. For an overview of Ontario's recent economic history and public finances, see Di Matteo (2013b).

high costs for electricity[16] and energy, a reliance on manufacturing tied to a US market that saw a major downturn, and a political culture increasingly focused on government economic intervention as a solution to the economy's problems.

In the absence of its own resource commodity boom that might have compensated for some of these economic characteristics, Ontario's problems intensified in the period after 2000 and the province has resorted to supporting its accustomed level of public spending by demanding more federal transfers and accumulating more debt.[17] Low interest rates were a factor enabling larger deficits and debt. Ontario's transition into financial dependency at the provincial level is also paralleled by greater dependency at the individual level—yet another economic blow—as Ontario's social assistance rate is now the highest in the country.[18]

Assessing Ontario's Economic Malaise

Figures 3 and 4 provide an illustration of Ontario's declining income in relation to the rest of the country. From 1981 to 2004, Ontario's real per-capita GDP (a broad measure of income) was either above or equal to that of the rest of Canada (**figure 3**). A slowdown in per-capita GDP growth began in Ontario after 2000 and, starting in 2005, Ontario's real per-capita GDP fell below that of the rest of Canada. In other words, from 2005, Ontarians were, on average, poorer than the rest of the country. In 2004, Ontario's real per-capita GDP was 0.4% higher than the rest of Canada; by 2012, Ontario's real per-capita GDP was 5.6% lower.

Put differently, Canada's per-capita GDP excluding Ontario would be 2.2% higher in 2012 than it was with Ontario included. The reality is that Ontario's poor performance is dragging down the country as a whole.

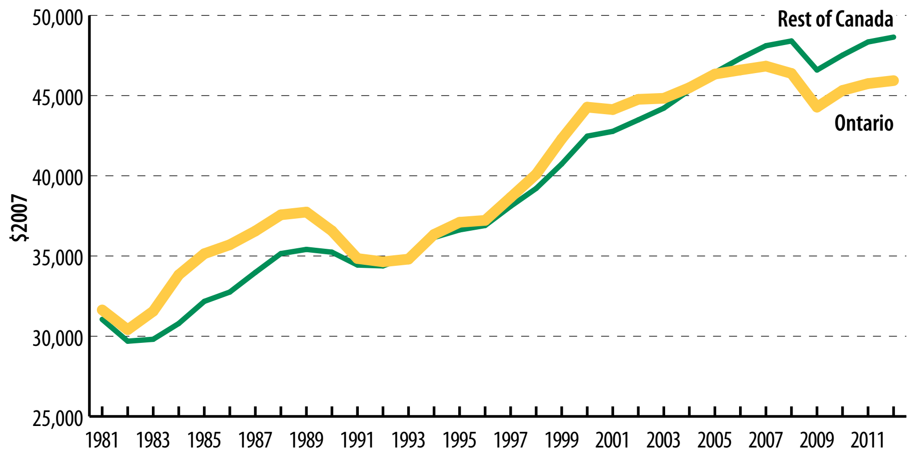
Figure 4 illustrates one of the reasons for the decline in Ontario's GDP: the average annual growth in real per-capita GDP. From 2001 to 2012, Ontario had the lowest average growth in real per-capita GDP of Canada's ten provinces. Indeed, per-capita real GDP from 2001 to 2012 for Canada as a whole grew, on average, by 0.8% annually. That figure increases to 1.2% (average annual increase in per-capita GDP) when Ontario is excluded.

Decline of export sector and investment spending

Figure 5 and figure 6 illustrate some explanations for this decline in Ontario's relative economic performance by examining Ontario's export and investment spending

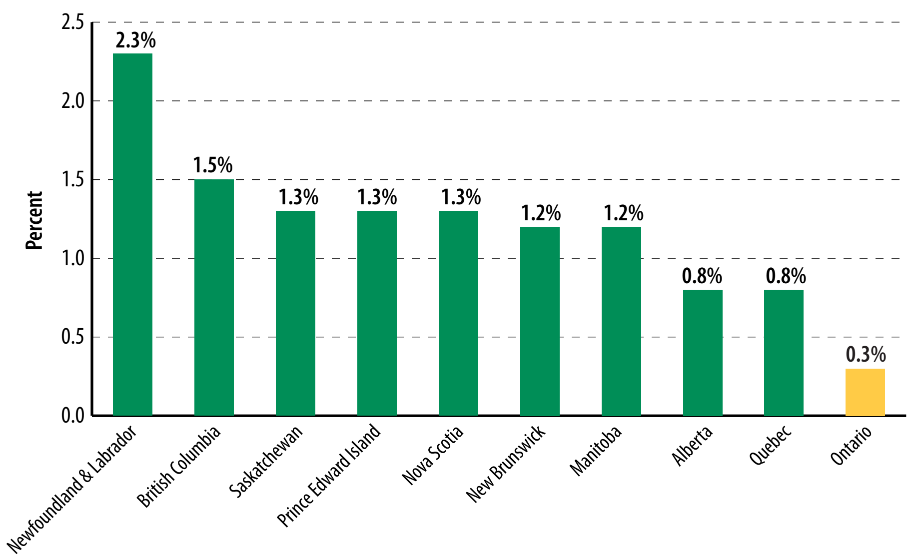
16. See McKitrick (2013).
17. The provincial funding of the Mowat Centre for Policy Innovation in 2010 as "Ontario's voice on public policy" has generated reports and op-eds on how Ontario is being shortchanged by the federal transfer system. See, for example, Zon and Mendelsohn (2013) and Zon (2013).
18. See Kneebone and White (2014).

Figure 3: Ontario and Canadian Real per-Capita GDP ($2007), 1981–2012



Sources: Statistics Canada, CANSIM tables 384-0038, 051-0001; calculations by authors.

Figure 4: Average Annual Real per-Capita GDP Growth Rates of Canadian Provinces, 2001–2012

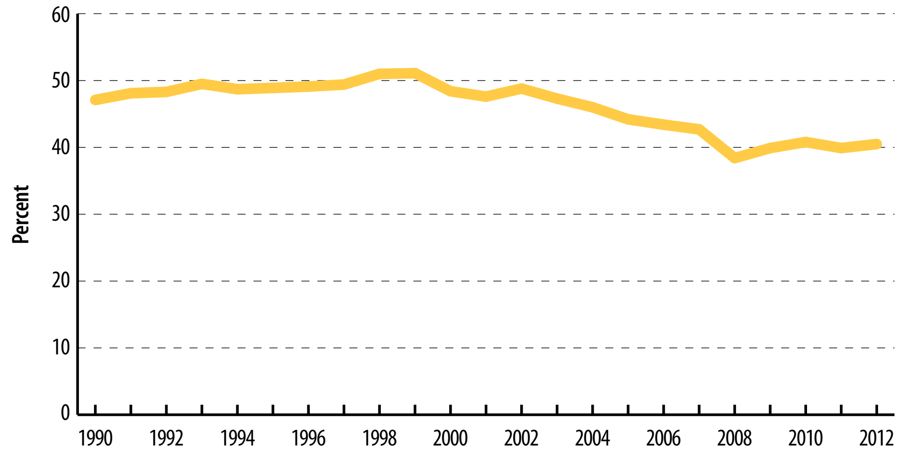


Sources: Statistics Canada, CANSIM tables 384-0038, 051-0001; calculations by authors.

performance. **Figure 5** shows that during the 1990s, Ontario generated nearly half of Canada's exports. This has since dropped to approximately 40%. Exports of goods and services in 2012 accounted for about half of Ontario's GDP—a much higher proportion than for the rest of the country. In addition, Ontario had a high concentration of exports—nearly 80%—going to the United States. This made Ontario's economy extremely dependent on the US market.[19]

19. It should be noted that the high share of Ontario exports going to the United States is a result of reliance on the automobile sector where, as part of an integrated production process, the same part can cross the border multiple times.

Figure 5: Ontario's Share of Canadian Exports, 1990–2012



Sources: Statistics Canada, CANSIM table 384-0038; calculations by authors.

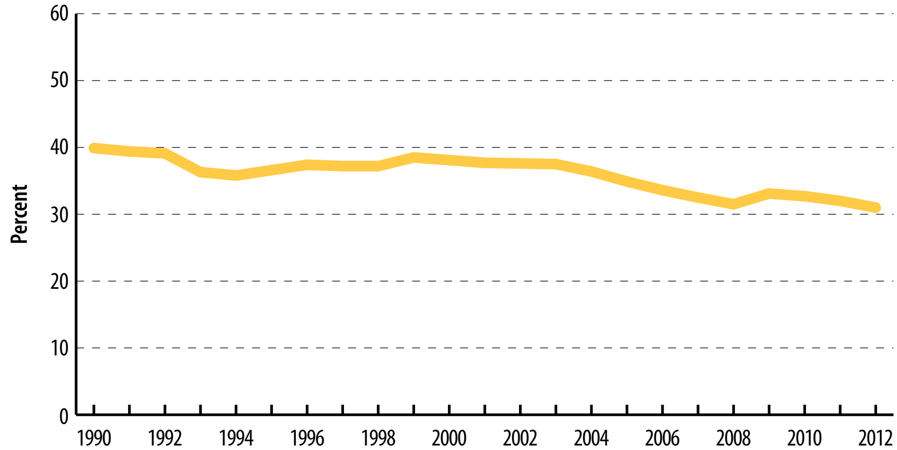
Another way to examine this decline is by looking at the share of Ontario's economy contributed by the export sector. In 2007, Ontario's export-to-GDP ratio was 56.7%. It is now 50.9%, reflecting a decline in the export sector's performance. Exports dropped 2.8% in 2008 and another 13.6% in 2009. While exports recovered in 2010, their growth rate fell in both 2011 and 2012.[20]

The severe economic recession in the United States in the wake of the 2008/09 financial crisis had a severe impact on Ontario's export sector. As well, Ontario's situation was affected by the recent appreciation of the Canadian dollar, which reduced the competitiveness of a manufacturing sector marked by a heavy reliance on automobiles and motor-vehicle parts that, in turn, made up a large share of Ontario's exports. In 2012, the total value of Ontario's merchandise exports was $162.6 billion of which 35% was motor vehicles and parts, 12% was precious metals and stones, 9% mechanical equipment, and 4% electrical machinery.[21]

A common measure of investment spending is gross fixed capital formation, which measures the value of new additions to productive assets such as buildings, machinery, and equipment. It is important because it represents an addition to the economy's productive capacity as well as the employment of new technology as new investment replaces old equipment. **Figure 6** illustrates the continuous decline in Ontario gross fixed capital formation as a share of Canadian gross fixed capital formation since 1990. Whereas in 1990, Ontario's share of Canadian capital formation closely matched its share of the national population,

20. Authors' calculations based on Statistics Canada, CANSIM Table 384-0038.
21. Source: Ontario, Ministry of Finance (2013a): Economic Data Tables, Ontario, International Merchandise Exports by Major Commodity, 2012 (Table 15), <http://www.fin.gov.on.ca/en/budget/fallstatement/2013/ecotables.html#eco15>.

Figure 6: Ontario's Share of Canadian Gross Fixed Capital Formation, 1990–2012



Sources: Statistics Canada, CANSIM table 384-0038; calculations by authors.

its current 31% share[22] is now well below its population share. This decline in productive investment suggests that in the future there will be growing economic productivity problems.

Labour market performance

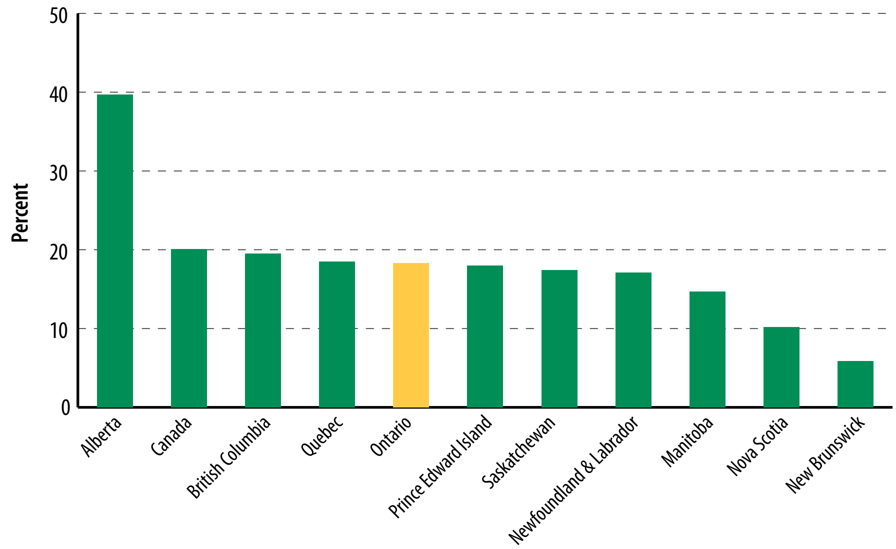
Interestingly enough, Ontario's labour market performance in terms of employment growth and unemployment rates has been mediocre but not as poor as one might expect given the preceding discussion. Figure 7a shows that over the period from 2000 to 2013, growth in total employment was below Alberta, British Columbia, and Quebec but Ontario still managed to grow total employment more than the remaining provinces. Figure 7b extends this analysis by examining private sector employment. After all, the resources required to support the government sector are provided by the private sector. Once employment in the government sector is excluded, Ontario's performance falls to third last, ahead of only Nova Scotia and New Brunswick. Specifically, growth in Ontario's private sector employment between 2000 and 2013 totalled 14.1%, compared to first-placed Alberta's 42.1%.

Put differently, private sector employment in Canada on average grew annually at 1.5% between 2000 and 2013. If Ontario is excluded, annual growth of private sector employment increases to 1.7%. Again, the under-performance of Ontario in growing private sector employment affects the performance of the country as a whole.

A clear explanation for Ontario's better-than-anticipated total employment performance (figure 7a) is rooted in its public sector. Over the period from 2001 to

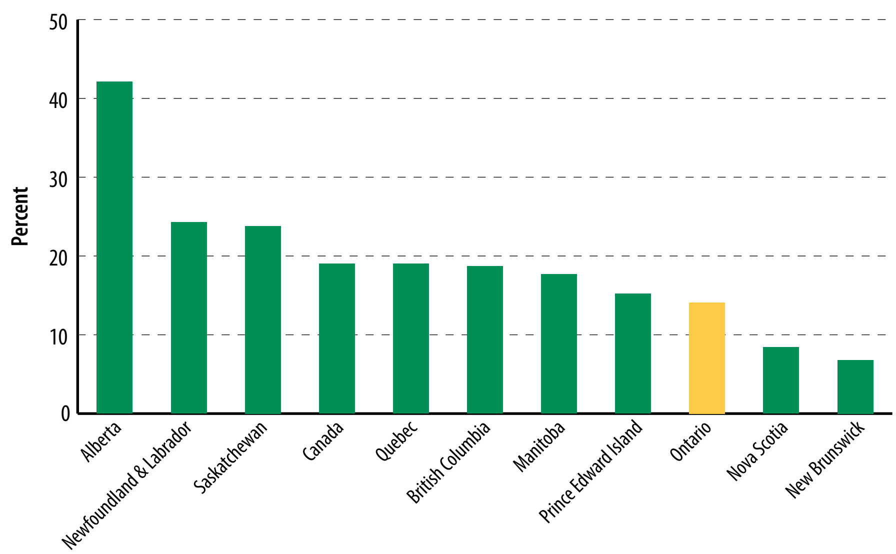
22. It should be noted that some of this drop was inevitable given the rapid growth in investment in Alberta's energy sector that has propelled Canadian investment spending and GDP. It should also be noted that new capital spending in Ontario has grown over time but the rate of growth slowed considerably after 2007. From 1992 to 2006, the average annual growth rate of new nominal capital expenditures was 4.7%. From 2006 to 2013, the growth rate fell to 1.9%. Authors' calculations based on data source: Statistics Canada, CANSIM Table 029-0005.

Figure 7a: Growth (%) in Total Employment in Canada and the Provinces, 2000–2013



Note: Total Employment includes public- and private-sector employees, and the self-employed.
Sources: Statistics Canada, CANSIM table 282-0002; calculations by authors.

Figure 7b: Growth (%) in Private-Sector Employment in Canada and the Provinces, 2000–2013



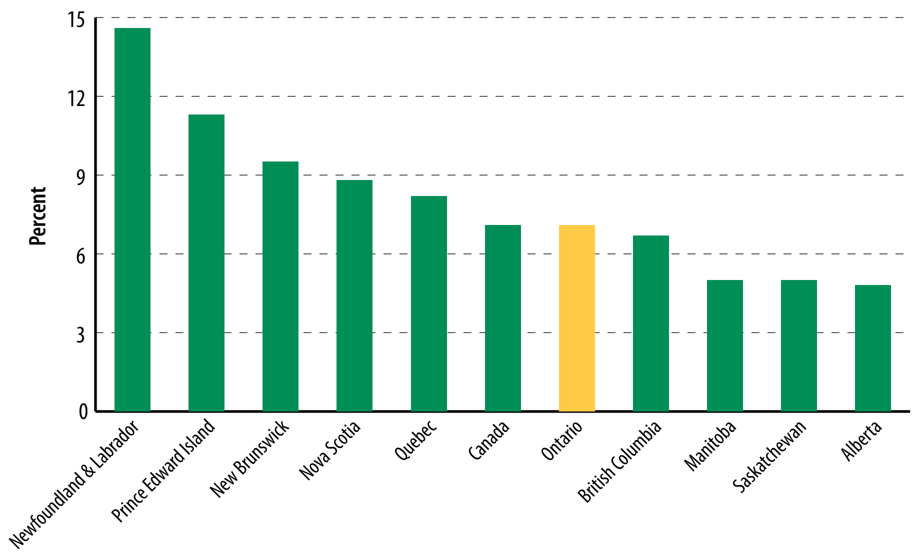
Sources: Statistics Canada, CANSIM table 282-0002; calculations by authors.

2011, for instance, Ontario's public sector employment grew, on average, at more than twice the average rate of private sector employment.[23] This development however brings its own complications as a result of the impact on the province's public finances, which are discussed later.

23. Over the period from 2001 to 2011, average annual public sector employment grew from 0.995 to 1.344 million jobs—an increase of approximately 35%. Meanwhile, private sector employment grew from 4.046 million to 4.352 million jobs—an increase of about 7.5%. Calculated from Statistics Canada, CANSIM 282-0012.

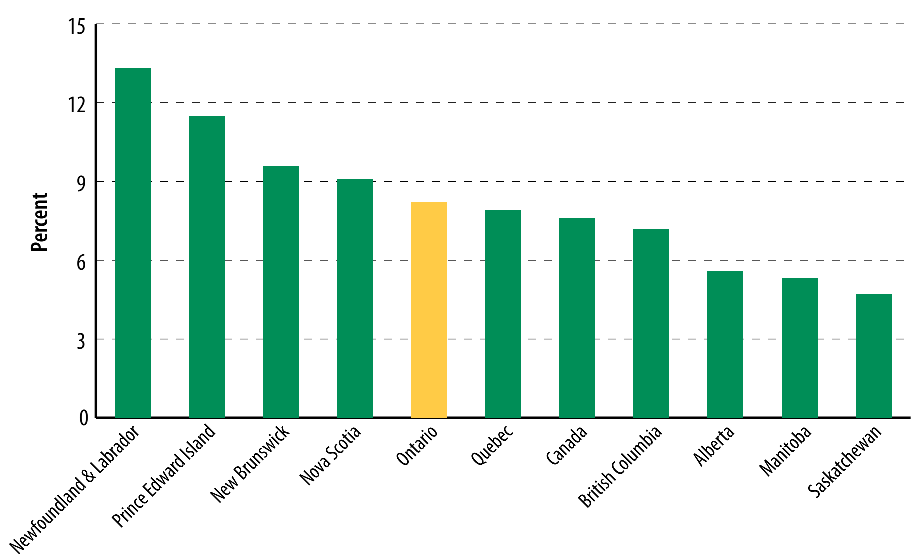
Figure 8a shows that Ontario's average unemployment rate over the period from 2000 to 2013 was lower than that of Quebec and Atlantic Canada but higher than in Western Canada. Specifically, Ontario ranked sixth of the Canadian provinces over the period with its unemployment rate of 7.1%, which was in line with the Canadian average for this period. **Figure 8b** shows the average annual unemployment rate for the most recent period, 2009 to 2013. Ontario was hit relatively harder by the 2009 recession and this is illustrated by its somewhat poorer unemployment rate performance during this period. Specifically, Ontario ranked fifth for its unemployment rate over this period, ahead of only the Atlantic Provinces.

Figure 8a: Average Unemployment Rate (%) in Canada and the Provinces, 2000–2013



Sources: Statistics Canada, CANSIM table 282-0002; calculations by authors.

Figure 8b: Average Unemployment Rate (%) in Canada and the Provinces, 2009–2013



Sources: Statistics Canada, CANSIM table 282-0002; calculations by authors.

Ontario's poor record on GDP growth, employment gains, and unemployment has weighed on Canada's overall performance

A different way to think about Ontario's higher-than-average unemployment rate is to consider what the national rate would be if Ontario were excluded. The national unemployment rate for the 2009–2013 period was 7.6%. It declines to 7.3% if Ontario is excluded.[24]

It seems clear on measure after measure that Ontario's poor economic performance over the last decade, and particularly during the period since the recession (2009), has weighed on the country's overall performance. Ontario's poor record on GDP growth, employment gains, and unemployment have meant a poorer national performance than would otherwise be the case. Simply put, an economically stronger Ontario means an economically stronger Canada.

Assessing the State of Ontario's Public Finances

Ontario only recently began to wrestle with its economic and fiscal situation via the commissioning of the Drummond Report.[25] Economist Don Drummond's report publicly articulated the dire state of both Ontario's public finances and its productivity slowdown, highlighting the fact that economic growth would not be resuming at past levels anytime soon. Ontario's public finances have seen expenditures rising faster than revenues for almost two decades, resulting in a massive accumulation of provincial debt, as the economic millstone of low productivity did not restrict the growth in government expenditure.

In 1981, Ontario had a net debt of $13.8 billion, which climbed to 235.6 billion by 2011.[26] According to the 2013 fall provincial economic statement, the provinces net debt is expected to reach $272.1 billion in 2013/14.[27] In 2012/13, Ontario accounted for 49.6% of provincial net public debt, reflecting a debt much larger than its population share.[28] Figures 9a to 9c provide a relative comparison of Ontario net provincial public debt with that of the other provinces. In 2012/13, Ontario reported the highest provincial net public debt of all the provinces (**figure 9a**). On a per-capita basis, Ontario has the second highest net debt level of the provinces (**figure 9b**). And finally, Ontario's net debt as a share of provincial GDP is also second highest among the provinces, behind only Quebec (**figure 9c**).

Despite the talk of 30% across-the-board spending cuts in the immediate wake of the 2012 Drummond Report, Ontario's budgetary actions to date have

24. Source: Statistics Canada, CANSIM Table 282-0002; calculations by authors.
25. Ontario, Ministry of Finance (2012). For summaries as well as the full report of the Commission, please see: <http://www.fin.gov.on.ca/en/reformcommission/>.
26. Di Matteo (2013b: 41).
27. Ontario, Ministry of Finance (2013a): table 3.9, <http://www.fin.gov.on.ca/en/budget/fallstatement/2013/chapter3c.html#table3.9>.
28. Canada, Department of Finance (2013a); Royal Bank of Canada (2014).

Figure 9a: Net Provincial Government Debt ($ millions), 2012/13

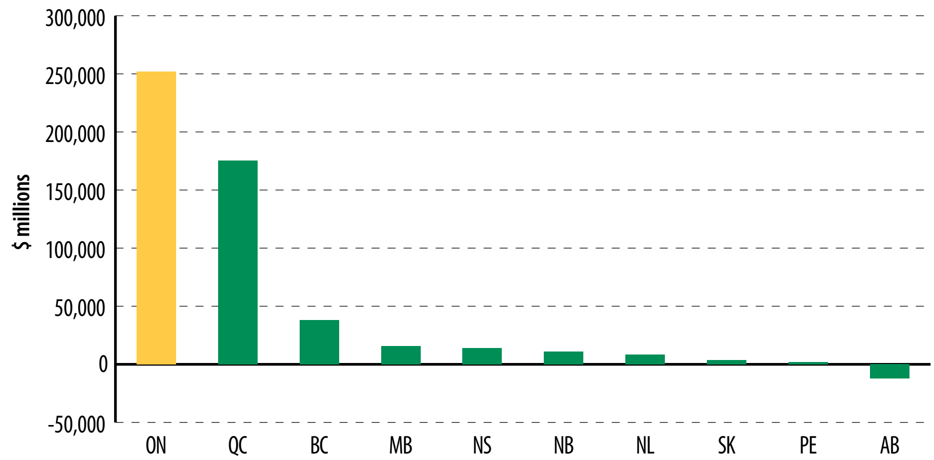


Figure 9b: Net Provincial Government Debt per Capita ($), 2012/13

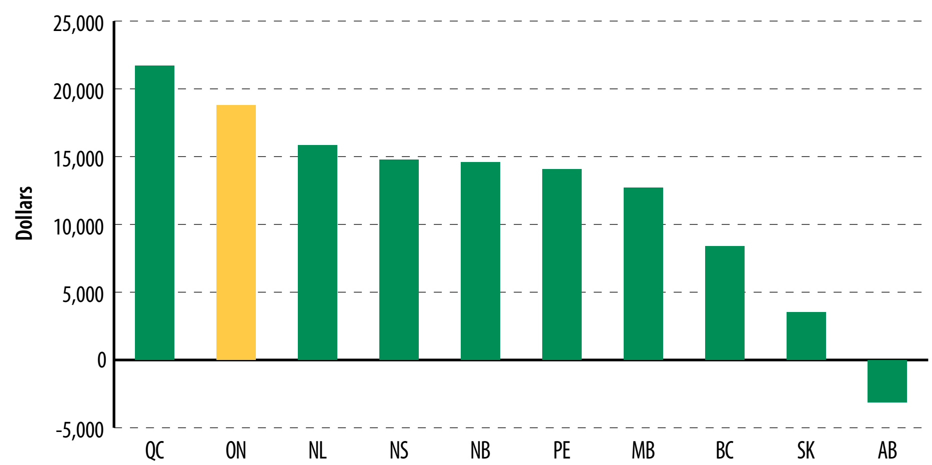
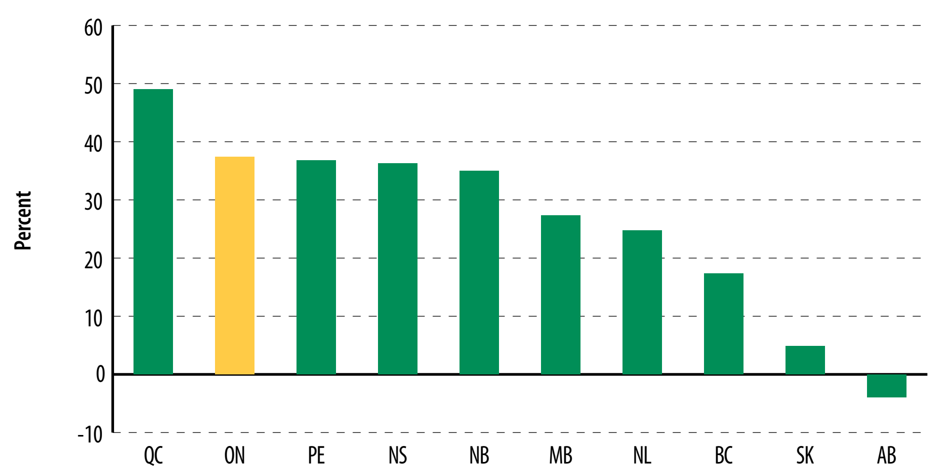


Figure 9c: Ratio of Net Provincial Government Debt to GDP (%), 2012/13

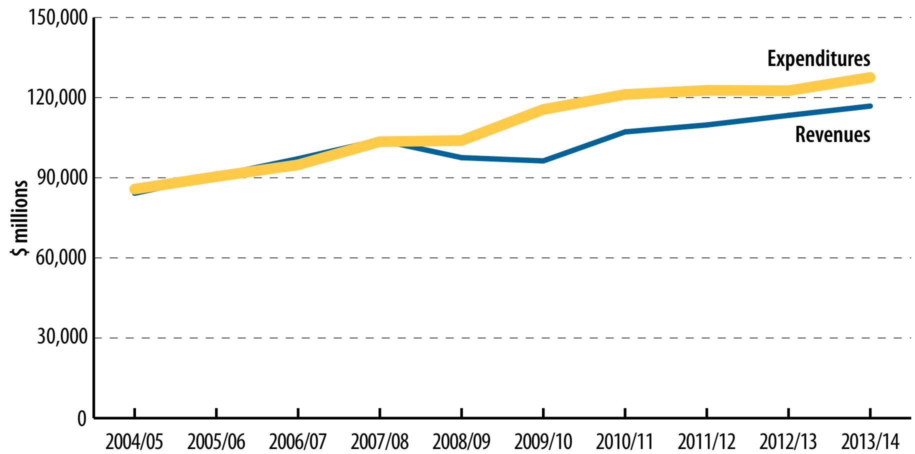


Sources: Canada, Department of Finance (2013a); Royal Bank of Canada (2014); Statistics Canada, CANSIM tables 051-0001, 384-0037; calculations by authors.

merely decelerated spending growth with the implicit underlying hope that revenues will catch up to spending once spending has been slowed. However, the evidence suggests that this approach is not having a great deal of success to date. As **figure 10** illustrates, there is still a large and persistent gap between provincial government revenues and expenditures.

Between the 2011/12 and 2012/13 fiscal years, total revenue growth was 3.3% while total expenditure stayed relatively constant for a deficit of $9.2 billion. However, according to the 2013 fall provincial economic statement, spending will grow from $122.6 billion in 2012/13 to $127.6 billion in 2013/14, an increase of 4.1%. Meanwhile, revenues are projected to grow from $113.4 billion in 2012/13 to $116.8 billion by 2013/14, an increase of only 3.1%.[29] There is an inherent but misplaced hope that revenue will make up what is still an $11.7 billion deficit.[30]

Figure 10: Ontario Provincial Government Revenues and Expenditures ($ millions), Ten-Year Summary, 2004/05–2013/14



Sources: Ontario, Ministry of Finance (2013a); Ontario, Ministry of Finance (2013b).

Government, Policy, and Competitiveness

When it comes to the economy, Ontario has lost its way given that "Ontario's economy is the essence of its culture."[31] Ontario's economic malaise is undermining its standard of living and its public finances. Yet, Ontario public debate has been blissfully unaware of the need to respond to economic change. Ontarians

29. Ontario, Ministry of Finance (2013a): table 3.4, <http://www.fin.gov.on.ca/en/budget/fallstatement/2013/chapter3c.html#table3.4>.

30. This amount takes into account $1 billion in reserve (Ontario, Ministry of Finance, 2013a).

31. Ibbitson (2001:187) argues that a defining historical characteristic of Ontario was a self-interested obsession with economic growth and wealth.

have long been the cornerstone of the Canadian federation and years of affluence have generated a culture of complacent contentment and inward-looking policies that take the standard of living for granted. This attitude best explains why many provincial government initiatives focused on regulatory and expenditure initiatives rather than taxation and competitiveness.[32] Indeed, additional competitive moves to reduce personal and corporate tax rates as well as harmonize the Ontario retail sales tax with the GST only began in the wake of the 2009 economic downturn. Yet, there is still progress to be made in this area given that Ontario in 2012 still had some of the highest combined federal and provincial personal income-tax rates in the country and higher rates than many US states.[33]

Chief among flawed economic policies was an industrial jobs creation strategy involving investment in alternative green energy sources that resulted in enormous subsidies to producers of higher cost electricity—an often neglected factor in discussions of its manufacturing decline.[34] Yet, fundamental economic lessons have still have not been learned given that Ontario is essentially blaming its low growth on the need for "a committed federal partner to support the province's plan for jobs and economic growth"[35] with investments in transit and in infrastructure to support mining in northern Ontario's "Ring of Fire"; and is diverting attention from the economy with plans to enhance the retirement income system with a provincial pension plan.[36] The provincial government's decision in January 2014 to raise the minimum wage to $11 means that Ontario will also be the province with the highest minimum wage.[37]

Of course, it should be noted that Ontario does have some legitimate economic grievances about the activities of the federal government and the operation of the Canadian federation. A report by the Ontario Chamber of Commerce noted that Ontario has historically supported the rest of the country via federal transfers and programs fueled by its wealth but has now fallen on hard times and needs to retool its economy. Indeed, it is estimated that diminished Ontario still contributes

32. The McGuinty era was active in its regulatory policies and actions included banning pit bulls and use of lawn pesticides. As well, both smoking and cell phone use in vehicles were banned (but then cell phone use in schools was considered) and the merits of mixed martial arts fighting debated. This proclivity has not ended under the Wynne administration given the recent foray into mandatory calorie menu labeling for restaurants in Ontario as well as changes to the minimum wage.

33. See Murphy, Clemens and Veldhuis (2013).

34. See McKitrick (2013).

35. Ontario, Ministry of Finance (2013a): 131, 137.

36. Indeed, the Ontario government has embarked on a consultation with Ontarians with respect to Canada's retirement system and appointed former Prime Minister Paul Martin as a special advisor on retirement income security. See: Ontario Ministry of Finance (2010) and Ontario, Office of the Premier (2014), <http://news.ontario.ca/opo/en/2014/01/paul-martin-named-special-advisor-on-retirement-income-security.html?utm_source=ondemand&utm_medium=email&utm_campaign=p>.

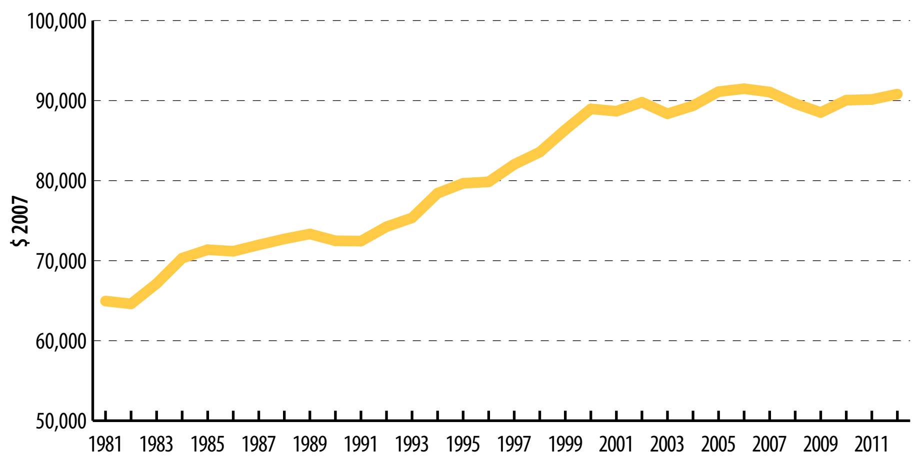
37. Ontario will have the second highest minimum wage in the country—after Nunavut. See: *CBC News* (2014, January 30), <http://www.cbc.ca/news/canada/toronto/ontario-raising-minimum-wage-to-11-an-hour-1.2516659>. Economic theory shows that minimum wage laws and living wage laws can have distortionary effects on labour markets that reduce employment though the size of the effect is an empirical question. For a recent overview and discussion. see Lamman (2014).

$12.3 billion dollars more to the federal government than it receives in transfers.[38] As well, while Ontario has 42% of all the unemployed workers in Canada, it only receives 28% of federal labour market funds and federal programs are hampering its ability to recruit skilled labour.[39]

Ontario desperately needs to retool its economy because economic productivity ... is stagnant.

Ontario desperately needs to retool its economy because economic productivity as measured by GDP per employed person is stagnant. **Figure 11** shows that, when measured as real GDP per employed person, productivity in Ontario rose steadily from the early 1980s to the early 21st century but has since leveled off. Moreover, in dealing with a faltering economic performance, a short-term solution has been an increase in government spending with associated public-sector job creation, particularly in the sectors of health and education.[40]

Figure 11: Ontario Real GDP per Worker ($ 2007), 1981–2012

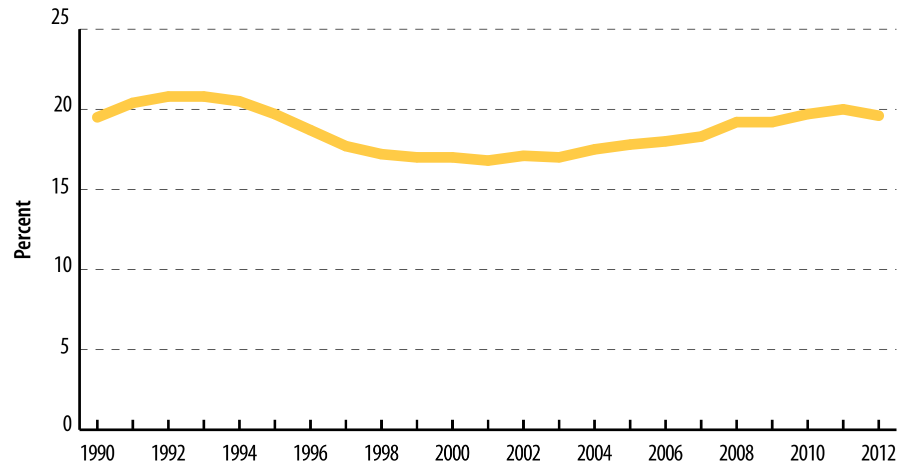


Sources: Statistics Canada, CANSIM tables 282-0002, 384-0038; calculations by authors.

As **figure 12** illustrates, the boom of the 1990s saw a shrinking of public-sector employment as a share of total employment whereas the period since 2000 has seen a reversal of the trend. Increased public-sector spending and employment may be warranted if it results in improved social outcomes but otherwise may divert resources from private-sector activities and result in lower economic growth.[41] Currently, the impact of the expanded public sector is affecting the government's inability to balance its budget (run deficits) and has not generally been observed to have positively contributed to GDP growth.

38. Ontario Chamber of Commerce (2012): 24.
39. For example, Ontario is allowed only 5% of the approximately 20,000 immigrants through the Provincial Nominee Program, which is a way of attracting skilled workers. See: Ontario Chamber of Commerce (2012): 10.
40. A particular expenditure example was noted by the Drummond Report for elementary and secondary education whereby, since 2002/03, student enrolment had declined by 6% whereas per pupil funding had grown by 56%. See: Ontario, Ministry of Finance (2012): 204.
41. For an international examination of public-sector size, economic growth, and societal outcomes, see: Di Matteo (2013a).

Figure 12: Ontario Public-Sector Employment as a Share (%) of Total Employment, 1990–2012



Notes: Total employment includes self-employment. Public sector includes federal, provincial, and local government, government agencies, crown corporations, and government funded establishments such as schools (including universities) and hospitals.

Sources: Statistics Canada, CANSIM table 282-0012; calculations by authors.

Why Canada Needs Ontario to Prosper

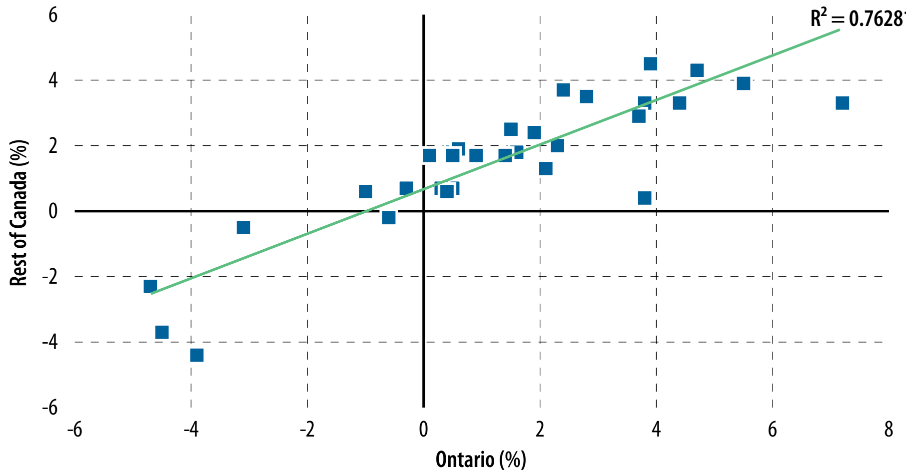
The first decade of the 21st century was a period of great economic challenge for Ontario as its economic importance in Canada diminished. While its share of the Canadian population continues to grow, its share of GDP has declined. In 2012, Ontario accounted for 39% of Canada's population but only 37% of its GDP. Between 2000 and 2012, Ontario's share of Canada's exports to other countries fell from 48% to 41% while its share of gross fixed capital formation fell from 38% to 31%. Real GDP per employee has been stagnant for the last decade and the share of public-sector employment has grown.

This laggard performance has an impact on Canada's economy even if international and continental economic integration of Canada's economic regions is more pronounced and the Canadian federation is more decentralized. Canada's provinces are still quite closely tied when it comes to their economic performance and the federation still maintains a web of transfer payments.

Growth in real per-capita GDP and employment in the rest of Canada is strongly and positively correlated with growth in Ontario.

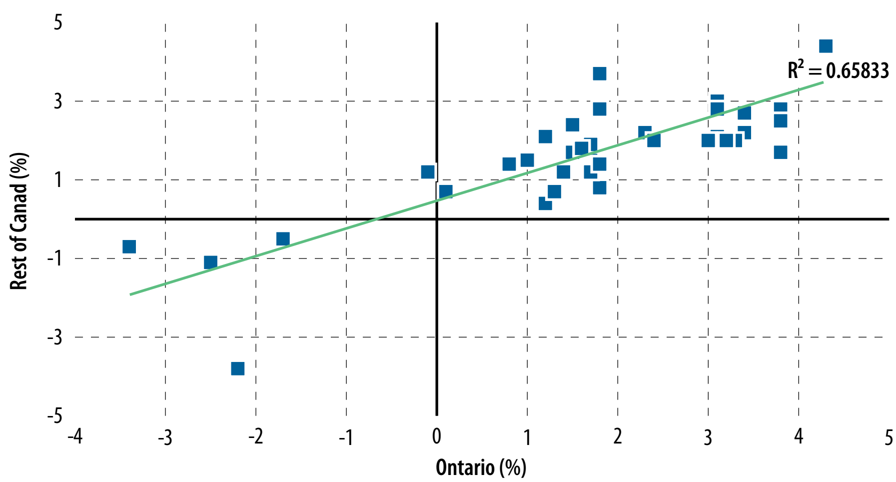
As **figure 13** shows, real per-capita GDP growth in the rest of Canada is strongly and positively correlated with that of Ontario. An R^2 of 0.76 means that 76% of the variation in the rest of Canada's real per-capita GDP growth rate can be explained by variations in Ontario's real per capita GDP growth rate. Similarly, **figure 14** shows employment growth in the rest of Canada strongly and positively correlated with that of Ontario. Again, the R^2 shows about 66% of employment growth in the rest of Canada can be explained by variations in Ontario's employment growth. Both these results suggest that there are still strong linkages between the performance of Ontario's economy and the economy of the rest of the country.

Figure 13: Real per-Capita GDP Growth Rates, Rest of Canada versus Ontario, 1982–2012



Sources: Statistics Canada, CANSIM tables 051-0001, 384-0038; calculations by authors.

Figure 14: Average Annual Employment Growth, Ontario versus Rest of Canada , 1977–2013



Sources: Statistics Canada, CANSIM tables 282-0002; calculations by authors.

The first decade of the 21st century saw Ontario's real per-capita GDP fall below that of the rest of the country and its average annual growth rate for real per-capita GDP become the lowest of the ten provinces. As a result, Ontario is now receiving equalization transfers; in 2013/14 it received $3.2 billion—accounting for 20% of equalization paid that year.[42] That Canada's largest province now receives equalization is not a positive economic development for the Canadian federation. With Ontario getting equalization, it also means that a majority of

42. See Canada, Department of Finance (2013b): Federal Support to Ontario, <http://www.fin.gc.ca/fedprov/mtp-eng.asp#Ontario>.

Canadians now live in an equalization-receiving province.[43] Having Canada's largest province as a recipient of transfer payments to maintain its level of public spending is further recognition that something is quite wrong with Ontario's economic performance.

It is tempting to argue that what has befallen Ontario is in some respects simply an economic rebalancing of the Canadian economy and federation and represents a natural evolution. Ontario's traditional economic dominance was out of proportion to its share of Canada's population and a function of the late nineteenth-century National Policy that created a protected set of manufacturing industries.[44] The move to freer trade and more competitive markets in the late twentieth century eroded the advantages of a protected market that Ontario and central Canada enjoyed and Ontario is now being forced to compete on a more level playing field.

Inter-provincial trade is not as important as it once was and Canada's economic regions in general are now even more integrated into north-south and international trade patterns. Indeed, Ontario was a leader in rapidly increasing North American economic integration during the 1990s.[45] However, the evidence suggests that Ontario has since not adapted well to the new and more competitive economic environment, especially given its performance with respect to productivity, investment spending, and exports.

Blaming all of Ontario's woes on the fiscal gap and federal policies is not a constructive strategy for reversing Ontario's economic and fiscal decline. Even if the fiscal gap with Ottawa were suddenly reversed and the additional funds allowed Ontario to balance its budget, Ontario would still face the challenges of stagnant economic productivity, a large accumulated debt, and an extremely competitive and changing international economy. Simply providing Ontario with more federal money without addressing its economic culture of government intervention and a penchant for flawed industrial job-creation strategies means Ontario's decline would persist.

One can also try to argue that Ontario's predicament is simply bad luck as it faces a resource commodity boom it cannot take advantage of given the absence in Ontario of oil, natural gas, potash, or fields of wheat and Canola™. Yet, Ontario has a natural resource frontier: northern forestry and mining as well as agriculture in southern Ontario. In particular, the mining frontier in Ontario's North—including chromite in the Ring of Fire in the James Bay lowlands—can serve as an investment frontier for the rest of the province much as it did in the late nineteenth and

43. For a discussion of this development, see: Milke (2014a).

44. The National Policy of Sir John A. MacDonald enacted in 1879 was really a triad of policies that involved creating an east-west economic corridor connecting the agricultural regions of the west, settled by means of a land and immigration policy, with manufacturing in central Canada via a transcontinental railroad, all behind a protective tariff wall. See: Fowke (1957).

45. Courchene (2004: 160) notes Ontario's rapid expansion in international exports as a percentage of its GDP from 30% in 1981 to 50% in 1998 while its interprovincial exports over the same period declined. See also: Courchene and Telmer (1998).

early twentieth centuries. However, this requires that the province embrace its north and develop private-sector partnerships as well as transportation and energy agreements on resource revenue sharing with the aboriginal First Nations. To date, negotiations with First Nations have been a particularly complicated endeavour, leading to some frustration on the part of mining companies in Ontario's north and the high profile suspension of activities in the Ring of Fire by Cliff's Resources in December 2013.[46]

Canada outside of Ontario has seen good rates of economic growth in per-capita GDP and employment but when Ontario is factored into national statistics, Canada's economic performance is brought down. As much as Canada boasts of weathering the post 2008/09 financial crisis in reasonably good economic shape compared to other G-7 countries, it could have performed even better with a more buoyant and productive Ontario.[47] There is a difference between being mediocre and being excellent. Ontario's failure to come to grips with its economic productivity and growth issues has serious implications for itself as well as the future growth of the Canadian economy. Even given the impressive performance of regional resource-driven economies outside Ontario[48] and increasing international and North American integration of Canada's economic regions, there is still a high correlation between Ontario's economic performance and the rest of Canada.

The end result is that Canada's economic performance remains tied to Ontario's economic performance. Canada can get by without Ontario doing well but could prosper even more if Ontario overcame its economic disrepair and began firing on all cylinders. Ontario is a vast pool of human, physical, and financial capital that is not living up to its potential. Ontario owes it to itself and the rest of Canada to put its public finances in order, boost its economic productivity, recognize that government economic intervention has its limits, and unleash its private sector on its northern resource frontier. Ontario can do better.

46. Indeed, the major activity in Ontario's North appears to be planning for a boom that has yet to emerge and reports with little follow-through, such as the "Rosehart Report" (Rosehart, 2008) followed by the *Growth Plan for Northern Ontario* (Ontario, Ministry of Infrastructure,2011) that has now led to "Joint Task Forces" on regional economic planning zones and a Northern Policy Institute to study northern issues. While constantly discussing economic development, the provincial government generated investor uncertainty with its Far North Act legislation, which sequestered 225,000 square kilometres—approximately 20% of Ontario's land—as a conservation area. While Ontario is so vast that 20% of its land may not seem a significant amount, it is not known if the most valuable or least valuable parts of the region's resource potential will be sequestered.

47. For example, if in 2013 Ontario had had the same annual unemployment rate as Alberta—4.6% as opposed to its 7.5%—then the unemployment rate in Canada as a whole would have been 6% rather than 7.1%. (Source: authors' calculations).

48. It should also be noted that Canada without Ontario would be a more resource-driven economy and therefore more subject to boom-and-bust in commodity prices. In 2012, the share of GDP accounted for by natural-resource industries (defined as agriculture, forestry, fishing, hunting, mining, quarrying, and oil and gas extraction) was 8.9%. In the absence of Ontario, this share would be 13%. Source: Statistics Canada, CANSIM Tables 379-0030 and 379-0038.

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CANSIM Table 282-0012: Labour force survey estimates (LFS), employment by class of worker, North American Industry Classification System (NAICS) and sex, annual (persons x 1,000).

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CANSIM Table 379-0030: Gross domestic product (GDP) at basic prices, by North American Industry Classification System (NAICS), provinces and territories (annual, dollars).

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Nous envisageons un monde libre et prospère, où chaque personne bénéficie d'un plus grand choix, de marchés concurrentiels et de responsabilités individuelles. Notre mission consiste à mesurer, à étudier et à communiquer l'effet des marchés concurrentiels et des interventions gouvernementales sur le bien-être des individus.

Peer Review: Validating the Accuracy of Our Research

The Fraser Institute maintains a rigorous peer review process for its research. New research, major research projects, and substantively modified research conducted by the Fraser Institute are reviewed by experts with a recognized expertise in the topic area being addressed. Whenever possible, external review is a blind process. Updates to previously reviewed research or new editions of previously reviewed research are not reviewed unless the update includes substantive or material changes in the methodology.

The review process is overseen by the directors of the Institute's research departments who are responsible for ensuring all research published by the Institute passes through the appropriate peer review. If a dispute about the recommendations of the reviewers should arise during the Institute's peer review process, the Institute has an Editorial Advisory Board, a panel of scholars from Canada, the United States, and Europe to whom it can turn for help in resolving the dispute.

Editorial Advisory Board