ONTARIO'S ONE CYLINDER ECONOMY

Housing in Toronto and Weak Business Investment

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Executive Summary

Economic growth in Ontario has lagged Canada since 2003, reducing the province to 'have-not' status within Confederation. One theme that runs throughout the paper's analysis is the persistent weakness of Ontario's manufacturing sector, where output has fallen in absolute terms since the recession that began nearly a decade ago. Given that manufacturing is still Ontario's third largest industry, it is critical that its health be restored if the Ontario economy is to fully recover and prosper.

Manufacturing has recovered in other provinces in Canada, notably Quebec despite the well-documented woes of Bombardier. Manufacturing has become a larger share of Quebec's economy than of Ontario's, partly a reflection of how manufacturing has shrunk from 21.7% of Ontario's economy in 2002 to 12.1% in 2015. This suggests manufacturing's problems in Ontario cannot be blamed on global factors such as US export demand or the exchange rate, but are something specific to Ontario. The paper finds that the high cost of doing business in Ontario is the main drag on growth. These costs include everything from high electricity rates, the rising cost of labour and high income taxes to the indirect cost of a heavy regulatory burden. In particular, energy-intensive manufacturing has fared much better in Quebec than in Ontario in recent years, helped by Quebec's much lower electricity prices. As a result of the high costs in Ontario, the temporary weakness that inevitably accompanied the 2008/09 recession has become chronically weak growth. Sluggish growth has erased Ontario's historically lower unemployment rate than in neighbouring Quebec, a province long known for extensive government intervention in the economy and large government debts.

More broadly, business investment in manufacturing and elsewhere has languished during the recovery. Overall, investment plans are for $50.9 billion in 2017, compared with their pre-recession peak of $53.8 billion. Most of this reluctance to invest originates in the manufacturing industry. This reflects a number of factors. While the automobile industry has retooled its existing plants, no new plants have opened since 2009 while existing capacity continues to be shuttered, with another line scheduled to close this summer. Investment has fallen even more in other industries ranging from petroleum refining to lumber, computers and electronics, and rubber and plastics.

Chronically weak growth in manufacturing has left Ontario increasingly dependent on housing, which has contributed over 29% of its income growth in the past year, even before a spike in housing starts and prices early in 2016. Besides a sharp increase in housing starts in Toronto, there has also been a marked shift from the building of single-family homes to multiple-unit

dwellings, mostly apartment and condominium buildings. The squeeze on the supply of single-family homes, partly the result of land use regulations, helped fuel the surge in their prices. At the same time, the increased supply of multiple units is threatened by the extension of rent controls by the provincial government.

With a growing chorus of analysts and the federal government warning that a possible bubble in Toronto's housing market risks deflating, this leaves Ontario precariously dependent on a potentially unstable and unsustainable source of growth. A correction in the Toronto housing market would leave both Ontario's economy and government fiscal projections vulnerable to a downward revision.

Introduction

Ontario's economy has clearly lagged behind Canada's national average over the past 14 years. Most visibly, its status shifted from a "have" to a "have not" province within Confederation that receives equalization payments as its per-capita income slid below the national average (Cross, 2015: 3). Ontario's unemployment rate for decades was between two and three percentage points lower than Quebec's; now they are equal, with the unemployment rate in Montreal below Toronto's. This is a shocking reversal: as one recent history of the province noted, "Ontarians, more than any other Canadians, expect their province to be prosperous" (Ibbitson, 2001: 160).

Persistently weak business investment is a major reason that Ontario's economy has struggled in recent years. Investment in manufacturing has been especially poor during the recovery from the 2008/09 recession, a worrisome development for what is Canada's traditional industrial heartland. Investment in Ontario's factories remains one quarter below its level before the recession, when manufacturers were faced with negative forces such as a high dollar and oil prices. While these headwinds have dissipated in recent years, investment in Ontario's manufacturing sector has not picked up. The reluctance of firms to invest in Ontario's factories reinforces the ongoing slump in manufacturing exports and limits its capacity to grow in the future.

Why have a lower dollar and cheaper oil prices failed to reignite business investment and manufacturing in Ontario? This paper looks at the recent trend of Ontario's economy and how government actions that increase the cost of doing business in Ontario are hampering its growth. These costs include the direct costs of high electricity and labour, uncompetitive tax rates that high government debt promises to keep elevated, and the indirect costs of widespread uncertainty about further government regulation.

With weak business investment and sluggish manufacturing exports, Ontario is increasingly dependent on the housing market, especially that in the Greater Toronto Area, to sustain its economic growth and government revenues. Ontario's economy is vulnerable to a reversal in this market, which has contributed over one quarter of all income growth in the past year, when housing surged even as exports and investment stagnated.

Business Investment Fails to Recover

Firms plan to invest $50.9 billion in Ontario in 2017. [1] This is up slightly from $49.4 billion in 2016 but below the $52.1 billion posted in 2015. Business investment has not recovered to its pre-recession peak of $53.8 billion. [2] The reluctance of manufacturers to invest is the major reason business investment in Ontario has not recovered to pre-recession levels. In the three years before the recession, annual investment in factories in Ontario averaged $8.0 billion a year. The recession lowered investment to just over $5 billion for several years. However, investment in Ontario's factories continued to languish well into the recovery, plumbing a low of $4.8 billion in 2013, five years after the recession ended. Since 2013, it has averaged $6.2 billion, still nearly one quarter below its average level before the recession, when Ontario's factories were wrestling with the effect of increased competition (especially from China for its once-sizeable textile and clothing industries), a higher exchange rate, and high oil prices.

Ontario is the only province where manufacturing investment has failed to recover. In the rest of Canada, manufacturing investment recovered to its pre-recession level by 2011 and then continued to grow to a peak of $12 billion in 2015 (**figure 1**). Investment then dipped in 2016 and 2017, reflecting declines in Alberta (due to the oil price slump) and British Columbia (where a major investment in a smelter was completed).

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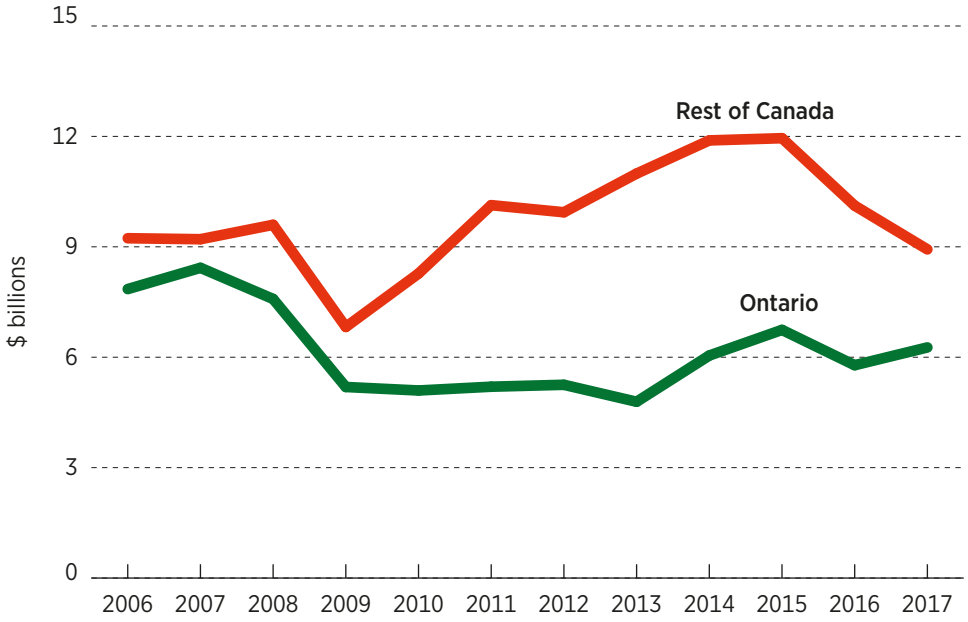
[1] The level of business investment is actually slightly lower, but the large investments government is making in urban transit in Toronto and Ottawa are not separated within the transportation industry total in Statistics Canada's data for the provinces. All provincial investment data is from Statistics Canada, 2017c: CANSIM table 029-0045.

[2] Business investment is defined in the National Accounting sense, which is approximated by total investment less investment in the industries dominated by the public sector, notably health, education, public administration, and urban transit. While Statistics Canada separates urban transit investment from total transportation at the national level, it does not do so at the provincial level for reasons of confidentiality, so in this paper all of transportation is excluded. Note that business investment is conceptually quite different from the series on private-sector investment published by the Survey of Public and Private Investment in Canada. For example, investments made by large publicly owned hydro companies such as Hydro Ontario or liquor-board monopolies are included in public-sector investment in this survey, but are in business investment in the National Accounts because they are deemed to be operating for profit even if they are owned by the government. In total, business investment in 2016 totalled $197.2 billion, while private-sector investment was $152.2 billion, a difference of 22.8%. Taking total investment and subtracting out the three public-dominated industries yielded $184.2 billion, much closer than the private-sector total.

Figure 1: Manufacturing investment in Ontario and the rest of Canada, 2006–2017

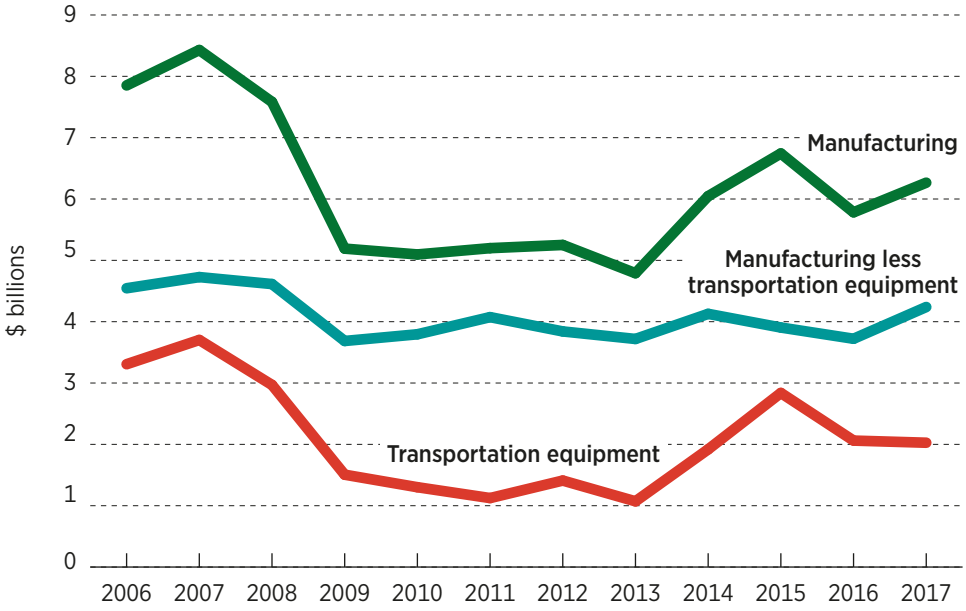


Source: Statistics Canada, 2017c: CANSIM table 029-0045.

Manufacturing investment in Ontario edged up from its post-recession low of about $5 billion to just over $6 billion over the last four years. This growth largely reflects developments in the automobile industry. Investment in transportation equipment (which in Ontario is almost all automobiles) increased from $1.1 billion in 2013 to an average of $2.2 billion between 2014 and 2017 (**figure 2**). These investments include the retooling of several automobile plants, notably a large investment by Chrysler in its Windsor minivan plant in 2015. Retooling and modernizing existing automobile plants are important to securing future production for these plants. However, they do not reflect a net expansion of automotive capacity in Ontario; in fact, that capacity will fall when General Motors closes a shift at its CAMI plant in 2017. Even with the investments related to retooling some automobile plants, investment in this sector in Ontario remains well below its average of $3.4 billion in the three years before the recession, reflecting the absence of greenfield investments in new automobile plants (the all-time peak of automobile investment in Ontario was $4 billion in each of 1997 and 1998) (Statistics Canada, 2014: CANSIM table 029-0009).

Without the opening of new plants, Ontario's importance in the North American automobile industry has steadily shrunk. Ontario saw its share of North American automobile output fall from a high of 17% in 1999 to 13.4% in 2013 (TD Economics, 2013). This reflects the combination of plants closing in Ontario and new plants opening exclusively in the United States and Mexico since 2009 (when the last new automobile plant in Ontario opened at Toyota's

Figure 2: Manufacturing investment in Ontario, with and without transportation equipment, 2006–2017



Source: Statistics Canada, 2017c: CANSIM table 029-0045.

Woodstock facility). Another sharp reduction will occur in the second half of 2017 according to the Bank of Canada, when automobile assembly in Canada is forecast to decline 10% as GM phases out one shift at its CAMI plant (on top of the transfer of production of 72,000 Camaros from Oshawa to Michigan late in 2015) (Bank of Canada, 2017: 16).

Despite these challenges, the automobile industry has posted one of the better outcomes for manufacturing investment in Ontario in recent years. Outside of the automobile manufacturing, investment has fallen sharply in a wide range of industries. Compared with averages before the recession, capital spending declined by about 30% in petroleum refining and non-metallic minerals; by 50% in printing, computers and electronics, lumber, and textiles; and by 60% or more in rubber and plastics, paper, and furniture. Only four industries—primary metals, chemicals, metal fabricating, and machinery—made investments comparable to their levels before the recession. Again, it must be pointed out that comparing investments to their pre-recession levels between 2006 and 2008 means comparing to a period that, at the time, was routinely described as a crisis for Ontario manufacturing. **[3]** Ontario's factory sector has

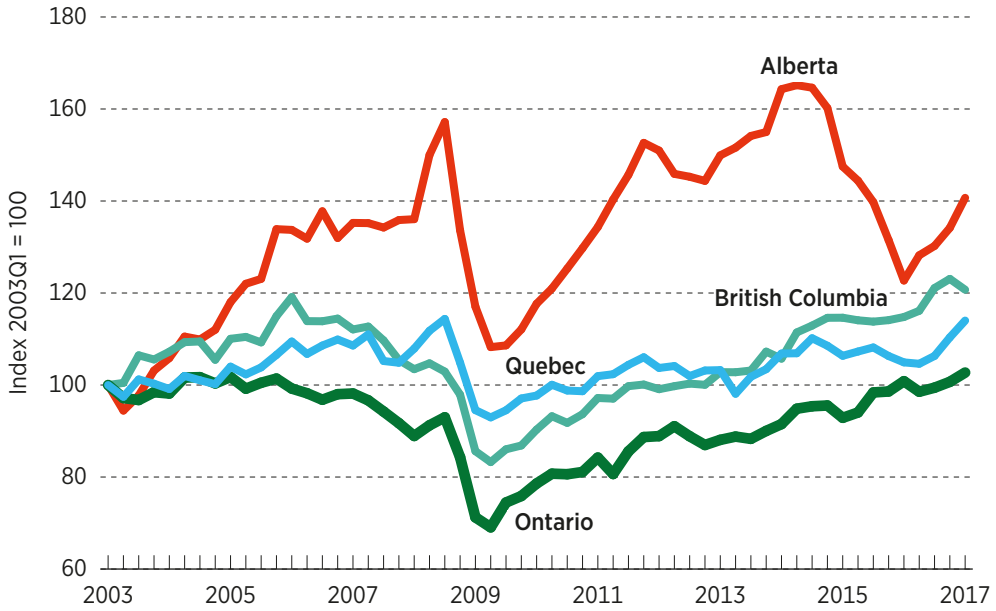
[3] Unfortunately, Statistics Canada's new industry classification does not extend beyond 2006. Under the new classification, investment in manufacturing in Canada was $17.9 billion in 2014; under the former classification, it was $18.9 billion, a difference of about 5%. Manufacturing investment in Ontario peaked at over $10 billion in the late 1990s (Statistics Canada, 2014: CANSIM table 029-0009).

benefitted since 2014 from a lower exchange rate and falling oil prices. As well, the juxtaposition of low manufacturing investment despite capacity utilization rates "close to their historical highs" was noted by the Bank of Canada (Bank of Canada, 2017: 18). Despite these stimuli, firms remain unwilling to commit to long-term investments in factories in Ontario.

Weak investment is one reason that the growth of Ontario's manufacturing sales has lagged behind that of all other provinces since 2003 (**figure 3**). In fact, sales by Ontario factories have been essentially unchanged since 2003, compared with gains of 14% in Quebec, 40% in Alberta, and 20% in British Columbia. Almost all manufacturing industries in Ontario except the food industry have struggled to return to their pre-recession levels. **[4]** The Export Development Corporation does not see a major improvement in 2017, as it forecasts only 2% growth in Ontario's exports, the lowest of any province except Nova Scotia (EDC, 2017: table 4).

It is difficult to see how Ontario can return to high rates of sustained economic growth without a flourishing manufacturing sector. Even with its struggles over the past decade, manufacturing in Ontario remains one of its

Figure 3: Index of manufacturing sales in Ontario, Quebec, Alberta, and British Columbia, 2003–2017



Source: Statistics Canada, 2017i: CANSIM table 304-0015.

[4] While the high-tech industries in computers, electronic products, and electrical equipment saw sales recover from $11.3 billion in 2013 to $12.9 billion in 2016, they remain below their high of $15.2 billion in 2008 and their peak of $23.2 billion during the boom in information and communication technologies (ICT) in 2000.

largest sources of income and jobs. As a contributor to GDP, manufacturing's $79.3 billion of income ranks behind only finance and real estate as a source of income in 2013 (Statistics Canada, 2017j: CANSIM table 379-0028). As a source of jobs, manufacturing ranks third behind education and trade with 751,500 employees in 2016 (Statistics Canada, 2017h: CANSIM table 282-0088).

In addition, a healthy factory industry in Ontario is vital to manufacturing in Canada, with about 44% of all of Canada's manufacturing GDP and employment coming from Ontario. However, years of losses have sharply reduced the importance of manufacturing within Ontario's economy from 21.7% of GDP in 2002 to 12.1% in 2015 (Statistics Canada, 2017j: CANSIM table 379-0028). This drop reflects the outright contraction of manufacturing output in Ontario from $89.5 billion before the recession to $79.3 billion and growth in most other sectors of its economy. **[5]**

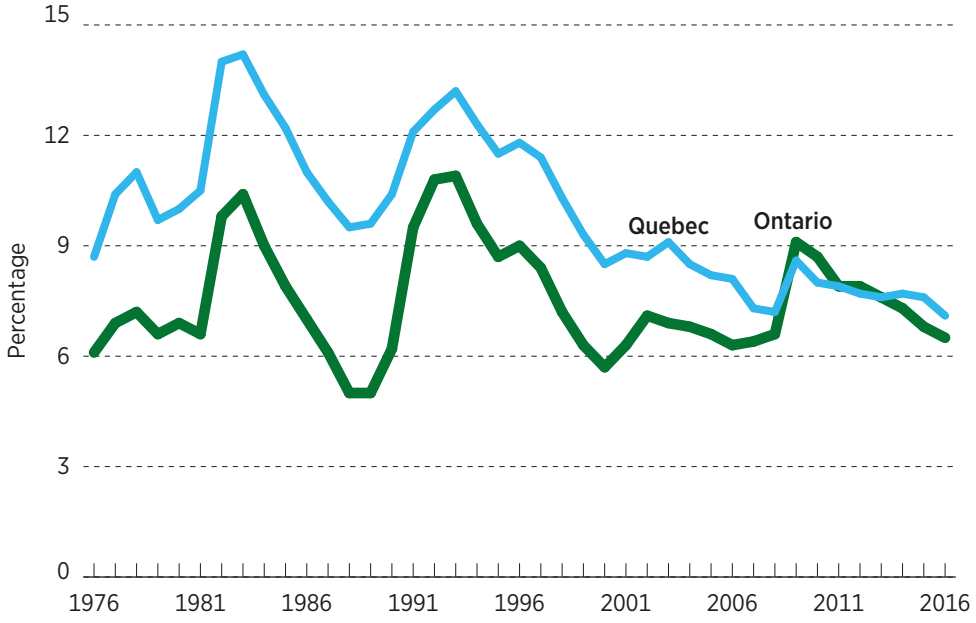
[5] The last year of data available for the level of current-dollar output by province is 2013, even though Statistics Canada publishes the share of manufacturing output through 2015.

Ontario Lags Behind Other Provinces

Ontarians have had to get used to some radical changes in their place within Confederation. Most notably, Ontario, once a "have" province, is now "have-not" province. It would be wrong to dismiss this as just the result of Alberta's pre-2014 oil boom. Ontario has fallen behind other provinces in some important economic yardsticks, notably unemployment. While little noticed in Ontario, it was front-page news in Quebec when its unemployment rate fell below Ontario's.

Historically, unemployment was always higher in Quebec than in Ontario, by four percentage points in the 1980s and 3 points in the 1990s, although the gap temporarily narrows during a recession, when Ontario's greater dependence on exports to the United States leads to more unemployment than it does in Quebec. Since 2000, the unemployment rate in Ontario has risen from 6% to 7%, while in Quebec it fell from 9% to 7% (**figure 4**). Before the recession began in 2008, Quebec's unemployment rate fell steadily while Ontario's was little changed, narrowing the gap to below one percentage point. Then, during the 2008/09 recession, Ontario's unemployment rate rose above Quebec's for the first time on record, and since then the two have been close.

Figure 4: Unemployment rate in Ontario and Quebec, 1976–2016



Source: Statistics Canada, 2017g: CANSIM table 282-0002.

A comparison of Montreal and Toronto summarizes how economic outcomes have been reversed between Canada's two leading cities. In the early 2000s (when Statistics Canada began calculating seasonally adjusted data for these cities), Montreal's unemployment rate was two percentage points higher than Toronto's. During the 2008/09 recession, Toronto's unemployment rate rose above Montreal's. Since mid-2015, unemployment in Montreal has fallen two percentage points to 6.8% in the first quarter of 2017, while in Toronto it was unchanged at 7.1% over the same period. The difference cannot be attributed to participation rates, which were unchanged in Montreal since mid-2015 but fell over a percentage point in Toronto (without this decline, unemployment would have risen in Toronto).

Between 2003 and 2015, real GDP per capita grew faster in Quebec (8.7%) than in Ontario (7.8%) despite Quebec's more rapidly aging population (Statistics Canada, 2017k: CANSIM table 384-0038; Statistics Canada, 2017d: CANSIM table 051-0001). One reason Quebec's economy has outperformed Ontario's over the past decade is that its manufacturing sector has fared relatively better. As noted earlier, manufacturing sales have stalled in Ontario since 2003, compared with a double-digit gain in Quebec. As a result, manufacturing is a larger share of Quebec's GDP (14.0%) than of Ontario's (12.1%) as of 2013 (the latest year available).

Some of Ontario's loss relative to Quebec reflects how the automobile industry has struggled to recover. However, it is also clear that energy-intensive manufacturers in Quebec have fared better than in Ontario. This may reflect the much lower cost of electricity in Quebec, as the next section documents. Between 2003 and 2016, manufacturing shipments in Quebec's paper and lumber industry fell about 12% compared to declines of over 25% in Ontario; non-metallic minerals shipments in Quebec were stable while they fell 5% in Ontario; for primary metals, Quebec's sales rose 44% while they dropped 5% in Ontario (Statistics Canada, 2017i: CANSIM table 304-0015). Some energy-intensive industries—notably firms that house servers in support of "cloud" computing—openly say they have chosen to locate in Quebec rather than Ontario because of the lower cost of energy.

The Cost of Doing Business in Ontario Is Rising

The previous sections have shown that Ontario's economy has fallen behind the rest of Canada in recent years, and notably Quebec, which has become even more dependent on manufacturing than Ontario. So why is Ontario's economy lagging and why are firms reluctant to invest in Ontario, especially in manufacturing? The woes of Ontario's manufacturing industry can no longer be blamed on external factors such as a high dollar and oil prices, since those have been reversed for some time. Instead, it is increasingly evident that the problems with Ontario's economy originate in its high cost of doing business. This section reviews three key factors contributing to this reality: high energy prices, high labour costs, and rising government debt, and discusses how government policy is contributing to each.

High energy prices

Ontario's high costs extend across a wide range of variables, including electricity, labour, and taxes. As well, the large deficits posted by the provincial government since 2003 augur future tax increases. Additional uncertainty about costs in the future resulted from the Ontario government's decision to undertake an extensive review of its labour legislation. This is in addition to its recent extensive reviews of everything from an Ontario pension plan to social assistance, minimum wages, and a cap-and-trade pricing system for carbon emissions. It is notable the government has not deemed it necessary to conduct expert reviews of the burden of public debt or the rising costs of education and health care or soaring electricity rates.

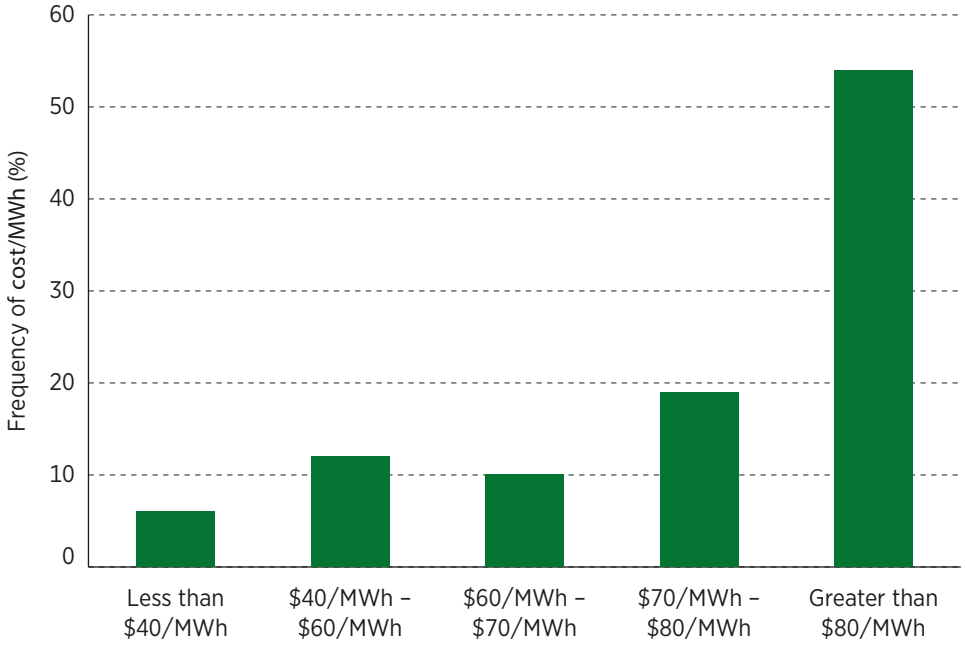
Ontario's electricity costs are the highest in North America for most businesses, especially the 1.1 million self-employed in the province who do not qualify for the rate reductions granted some businesses. The reasons for this would require its own paper, but include the Ontario Auditor General's estimate that hydroelectric costs were raised $37 billion by government policy mistakes (Auditor General of Ontario, 2015: 23). Large industrial users received some relief from high electricity rates. Industry will face further increases in the cost of energy, now that the Ontario government has introduced its cap-and-trade system for carbon pricing.

The exact price that firms pay for electricity varies, as the Ontario government has introduced a rate schedule that varies as a result of a number of factors including government rebates for the largest users. This paper examines what firms actually pay according to the fairly limited information in the government's quarterly electricity reports (Ontario/IESO/OEB, 2017). The

largest users receive the largest discount in electricity rates. As a result, we would expect relatively more large firms to be using electricity, which skews the results.

The distribution of average all-in prices for directly connected [6] industrial users in 2016 shows that prices exceeded $80 per megawatt-hour (MWh) roughly 55% of the time. The next most common price was $70 to $80, with users paying this rate about 19% of the time. The least common price was the lowest tariff below $40, which applied only about 5% of the time (**figure 5**). Overall, industrial users mainly pay all-in prices above $80 per MWh and rarely (about 16% of the time) pay less than $60 per MWh. [7]

Figure 5: Transmission-Connected Industrial Rates, 2016



Note: Does not include the Northern Industrial Electricity Rate Program.

Source: Derived from Ontario/IESO/OEB, 2017: 14, figure, *Transmission-Connected Industrial Rates (2016)*. Permission requested.

Another metric is to compare electricity rates offered by Hydro Quebec to attract business to that province. Even accepting the Ontario government's claim that the largest firms pay 8.35 cents per kilowatt-hour (kWh), Hydro Quebec still charges 38.1% less at 5.17 cents per kWh. It is not surprising, then, that firms that consume large quantities of electricity are choosing to locate

[6] Connected capacity accounted for 92% of total capacity in 2016.

[7] The figure and the prices noted do not include the Northern Industrial Electricity Rate Program, which provides a rebate of $20 per megawatt-hour up to a maximum of $20 million. However, as of April 2015 there were only 16 companies in this program.

in Quebec rather than Ontario. A good example are the windowless, data centres the size of football fields opened in Quebec by firms such as Amazon, IBM, the French cloud computing giant OVH, Bell Canada, and Cogeco Data Services (*Montreal Gazette*, 2016, Dec. 20; *Fortune*, 2017, Apr. 1). Even those companies in the Northern Industrial Electricity Rate Program in Ontario, which the government claims pay 6.35 cents per kWh, face rates 18.9% above those in Quebec.

Why have rebates for large users of electricity not induced more firms to produce in Ontario? Some industrial users in Ontario benefit from lower prices offered in return for reducing their use in peak periods of electricity demand (IESO, 2017). This gives the illusion of a lower measured cost of electricity, when what happens is that the cost to business is shifted from electricity to the cost of foregone production during these peak periods. It is still more attractive to move production to other jurisdictions where firms can plan on maintaining a steady production schedule, uninterrupted by irregular interruptions in production depending on the vagaries of Ontario's electricity demand.

Furthermore, having a complex pricing system for electricity creates other problems for firms. A complicated set of rates makes it difficult and costly for firms to assess what their electricity bills might be, especially when all the nearby states and provinces have one simple rate. From the government's point of view, having a range of hydroelectric rates signals its flexibility and adaptability; from a prospective client's point of view, the variability of rates is a reminder of how hydroelectric rates are subject to bureaucratic (or worse, political) whim, injecting an additional amount of uncertainty about the future course of one of their most important costs. A decision to lower industrial rates in the run-up to an election in 2018 can easily become a post-election decision to raise rates to reward supporters from the environmental movement. Such capriciousness is not a stable basis for policy and does not inspire business confidence to invest in Ontario. As a result, only 24% of firms in Ontario are confident about the outlook for the economy (Ontario Chamber of Commerce, 2017: 12).

High unit labour costs

Ontario already had the highest unit labour costs in Canada outside of the Maritime provinces (Statistics Canada, 2016: CANSIM table 383-0029). **[8]** More initiatives by the current government will continue to put upward pressure on labour costs. The minimum wage, already the highest in Canada, rose in January 2017 and will jump to $15 an hour in the next 18 months. The government appointed a task force to review its labour legislation, and its interim report promised a wide range of measures that will increase the cost of employing people (see Keep Ontario Working with Philip Cross, 2016).

[8] Only Prince Edward Island and Nova Scotia had slightly higher labour costs than Ontario.

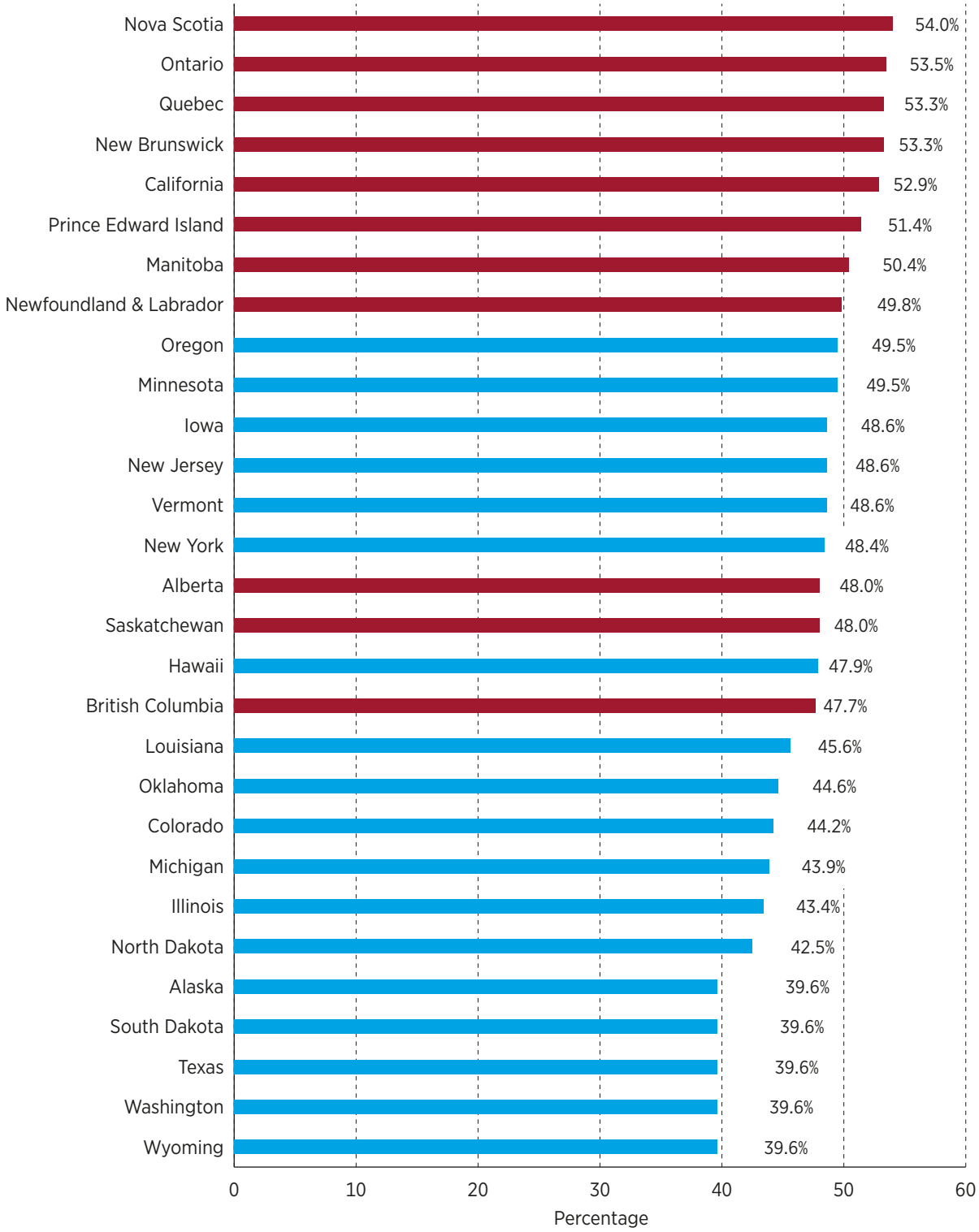
Meanwhile, a majority of states in the United States have adopted right-to-work legislation that makes it easier for employees to opt out of a union, reducing both wage rates and the cost of labour disputes.

Income taxes can impose another cost on hiring employees, especially those in high demand who have the most mobility. Ontario has the second-highest marginal personal tax rate of any province or state in North America at 53.5%, nearly 10 percentage points higher than in Michigan just across the Detroit River (**figure 6**). Corporate income-tax rates in Ontario are more competitive than personal income taxes, as Ontario made a concerted effort to follow the federal government in reducing corporate rates. Using the marginal effective tax rate calculated by Jack Mintz, which combines statutory corporate income-tax rates with credits, deductions, and other taxes to measure what is actually paid, Ontario's rate of 18.9% is comparable to the Canadian average of 20.1% in 2016, but was above the rate in nearby Quebec (17.1%) (Bazel and Mintz, 2016) By the same measure, Ontario had the eighteenth highest corporate taxes out of 44 jurisdictions in the Organisation for Economic Cooperation and Development.

Rising government debt

High levels of provincial government debt in Ontario promise a continued high tax burden in the future, unless forceful steps are taken to reduce spending. Ontario's net provincial government debt as a percentage of GDP rose to 39.9% in fiscal 2015/16, the third highest in Canada (Lammam, Palacios, MacIntyre, and Ren, 2016: 4) Most of this higher debt reflected increased government spending, despite the absence of the external shock of a recession for eight years and the boom in Toronto's housing market (Murphy, Emes, Clemens, and Veldhuis, 2015: iii).

Figure 6: Combined statutory marginal personal income-tax rate (%) in Canadian provinces and selected US states, 2016



Notes: Personal income tax rates include surtaxes where applicable. Quebec's tax rate is adjusted for the federal abatement. For US states, local income taxes are excluded.

Source: Murphy and Palacios, 2017: 27, fig. 2

Housing Is Propping Up Ontario's Economy

With business investment and manufacturing exports chronically weak in recent years, Ontario has been increasingly reliant on housing to sustain economic growth. In the year ending in the fourth quarter of 2016, the volume of housing expenditure rose 7.8%, on top of a 7.1% gain in 2015, the fastest increases of any sector. Factoring in the soaring price of housing, and it has contributed 29.0% of nominal GDP growth over the past four quarters, well above its 7.8% share of GDP in 2015 (Ontario Ministry of Finance, 2016). The surge in housing alone contributed 1.1 percentage points to nominal GDP growth in Ontario last year.

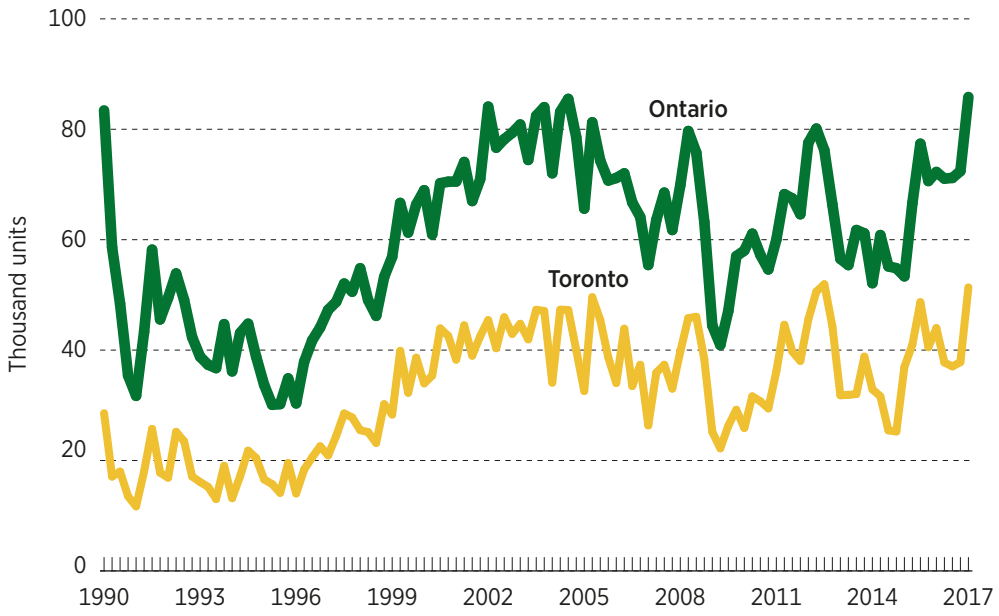
Ontario's dependence on housing undoubtedly increased over the winter, as both housing starts and existing home sales rose sharply. By the first quarter of 2017, housing starts in Ontario reached 85,844 units (at annual rates), their highest level on record back to 1990. Over half (60%) of these housing starts were in the Toronto Census Metropolitan Area, as starts in Toronto have doubled in less than three years (**figure 7**).

Besides a rapid increase in the numbers, there has been a marked shift in the composition of Toronto's housing starts over the past 15 years. As recently as 2002, there was more ground-breaking on single-family dwellings in Toronto than multiple units (21,967 compared to 21,690). Starts of single-family dwellings in Toronto have since fallen to about 10,000 units, while starts of multiple units (notably condominiums) have risen to 30,000 units, or three-quarters of new construction (Statistics Canada, 2017a: CANSIM table 027-0051). The low level of new construction of single-family homes has helped to push the price of homes beyond the reach of many people.

While residential construction shifted from building single-family homes to multiple units in recent years, the supply of rental units still did not keep up with demand. As the cost of buying a home in Toronto soared, "many households consciously decided to continue renting as shown by tightening vacancy rates across all apartment types" according to the Canadian Mortgage and Housing Corporation (CMHC, 2016: 2). The vacancy rate in the Greater Toronto Area fell from 3.1% in 2009 to a low of 1.4% in 2016. As a result, the price of renting smaller apartments (bachelor or one-bedroom) in Toronto exceeded Vancouver in 2016 (CMHC, 2015: 33). Attracted by high rents and a vacancy rate of only 1%, 33% of condos in Toronto are being rented out as apartments, up from 19% in 2008.

In 2016, multiple units accounted for three-quarters of housing starts in Toronto. Given this dependence on new construction of multiple units (mostly

Figure 7: Housing starts, Ontario and Toronto, 1990–2017



Source: Statistics Canada, 2017b: CANSIM table 027-0052.

apartment buildings and condominiums) to meet housing demand, it is all the more surprising for the Ontario government to extend rent controls for apartments built after 1991. This will immediately slow construction of new units and likely put even more pressure on prospective homeowners to bid up the price of homes.

Soaring prices are the most overt sign of the booming market for housing. Prices for existing homes in Toronto on average rose to $916,000 in March 2017, up 33% from $688,000 a year earlier, as it joined Vancouver in having by far the most expensive housing in Canada (Toronto Real Estate Board, 2017). Several reasons have been advanced to explain Toronto's housing market. One is that the boom in prices reflects higher demand as people are attracted by good employment prospects. However, the employment rate (the percentage of the adult population holding a job) in Toronto fell from 65.1% in 2001 to 61.8% early in 2017. Over the same period, the employment rate in Montreal rose from 60.4% to 62.5%, with no surge in house prices.

While employment has not been particularly strong in Toronto, there has been a marked influx of migrants both from the rest of Canada and from abroad. This inflow may reflect reduced opportunities elsewhere, especially in the three large oil-producing provinces in Canada that attracted many migrants before the crash in prices. While detailed data on migrants between cities is only available for 2015, clearly there already was a drop in people moving from Toronto to Calgary and Edmonton and an increase in people moving from Calgary and Edmonton to Toronto (with the former being larger than the latter) (Statistics Canada, 2017f: CANSIM table 051-0065). More international

migrants also arrived in Toronto; while the absolute inflow of 119,000 in 2016 was not particularly high by historical standards, the 30,000 increase from the very low number the year before was the third largest on record back to 1973, giving a sudden boost to demand just as prices were beginning to take off (Statistics Canada, 2017e: CANSIM table 051-0011). **[9]**

At the same time that population inflows from outside Toronto increased, there remain important restrictions on the ability of developers to increase the supply of housing. The Ontario government has introduced laws such as the 2004 Greenbelt Act and the 2005 Places to Grow Act to contain urban expansion and concentrate growth in 26 key areas around Toronto (Tindal, Tindal, Stewart, and Smith, 2016: 125) At the same time, many municipalities restrict builders to only one housing unit per lot, preventing multiple units from being constructed that would increase the supply.

Rising house prices can lift an economy in several ways. It stimulates new construction and boosts real estate commissions. Households may extract some of their higher wealth in real estate by borrowing more to finance current consumption. However, there is little evidence so far that homeowners in Ontario are doing this; retail sales growth early in 2017 was slightly below the national average.

There is a downside to higher house prices. Reports that house prices are beyond the reach of the average person may discourage young people from migrating to, or staying in, Toronto. More worrisome, the appearance of what is increasingly viewed by analysts as a bubble in prices raises the prospect of a crash in the future when prices return to more normal levels. Not only would this remove a major prop to Ontario's economy, it would mean many households acquired heavy debt loads for an asset that may become less valuable than the debt incurred to acquire it (creating so-called "negative equity" for homeowners). This would strain personal finances and increase personal bankruptcies.

The possibility of a housing bubble also puts the financial system at risk. Faced with soaring prices, home buyers have increasingly resorted to alternative mortgage lenders to finance their purchases. One of these lenders, Home Capital, was accused by the Ontario Securities Commission of having not disclosed fraud in its lending operations and experienced a sudden drop in its funding late in April. Early in May, Moody's downgraded their ratings for Canada's six largest banks. One should not, however, exaggerate the stress on Canada's financial system; unlike the US experience in 2008/09, Canada's financial system seems able to absorb increased losses from the housing sector. So it is highly unlikely there would be a repeat of the bankruptcies that occurred in the US financial system; it was the havoc wrought on banks, not the initial drop in housing prices, that made the US recession so devastating.

[9] Migration data are measured for the year from July 1 to June 30.

Late in April, the provincial government introduced several measures, including a tax on non-resident homebuyers, a tax on vacant units, and extended rent controls. These will curtail demand but also are likely to inhibit the supply of rental units. A softening of Ontario's housing market would be costly for the Ontario government, which may be why it needed prodding by the federal government (in the form of a letter from the Finance Minister) to take corrective action. Projections by Ontario's Fiscal Accountability Office show that a correction in the housing market would reduce Ontario's total revenues by $0.6 to $1.2 billion in fiscal 2017/18 and by $1.2 to $2.2 billion in 2020/21, depending on whether prices fell by 10% or by 20%. Revenue declines of this magnitude would put additional upward pressure on Ontario's already sizeable government debt (Lamman, Palacios, MacIntyre, and Ren, 2016).

Conclusion

Ontario's economy continues to struggle to recover from over a decade of sub-par growth, despite a housing-led pick-up in GDP growth last year. This shortfall has been most pronounced in its manufacturing sector, where firms remain reluctant to invest in Ontario even as manufacturing has recovered elsewhere in Canada.

The reasons for sluggish growth in Ontario, especially its vital manufacturing industries, centre on the high cost of doing business in Ontario. These include the high cost of labour, onerous income-tax rates, and especially the soaring cost of electricity, which has been a direct benefit to neighbouring Quebec where electricity prices are low. As a result, Ontario's advantage of having a historically lower unemployment rate than in Quebec has disappeared in recent years.

The major prop to Ontario's economy in the past year has been housing, especially Toronto's frothy market, where prices have outstripped incomes. With important sectors of Ontario's economy struggling, notably manufacturing and business investment, this has left the province increasingly reliant on housing for growth. During 2016, housing accounted for 29% of income generated by Ontario's economy, even before a further spike in housing starts and prices in the first quarter of 2017. This leaves growth in Ontario vulnerable to a cooling of its housing market. The slowdown may result from the internal dynamics of the housing market, as high prices attract more listings and depress demand, or from the actions taken by governments to cool the market, including taxes on foreign buyers of housing in the Toronto area and on vacancies as well as rent controls, which will discourage new building.

Ontario's vulnerability to a bursting of Toronto's housing bubble is ironic. The end of the oil price boom in Alberta in 2014 highlighted the inherent volatility of an economy based on natural resources, encouraging a smugness in central Canada that it had avoided such instability. Instead, Toronto is exposed to a potentially even larger source of instability than lower commodity prices.

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