QR 01

Institute for
Competitiveness & Prosperity

QUARTERLY REPORT 1
DECEMBER 2015

QR

FALL 2015

Welcome to the Institute for Competitiveness & Prosperity's *Quarterly Report*, the first of many to come. In this *Report*, we provide updates on key economic indicators for Ontario, including: Gross Domestic Product (GDP), job growth, unemployment, inflation, and exports. The Ontario government was very active in Fall 2015, and we discuss how new policy initiatives – namely the new provincial pension program, Premier Wynne's trade missions to China, the partial sell-off of Hydro One, and the recent infrastructure developments – will impact Ontario's economy.

STATE OF THE PROVINCIAL ECONOMY

ECONOMIC INDICATORS, ONTARIO						
Real GDP growth				**Unemployment rate**		
2015 Q1	2015 Q2	2015 Q3	2015 Q4	Sept '15	Oct '15	Nov '15
0.0	0.4	0.9*	0.4*	6.9	6.8	6.9
CPI inflation				**Export value/month ($ billion)**		
2015 Q1	2015 Q2	2015 Q3	2015 Q4	Fall 2014	Fall 2015	
0.0	1.1	0.4	0.0*	19.1	21.0	

Note: * Denotes a forecast. Unemployment data is seasonally adjusted. Export data is for the months of September and October, and only includes merchandise (not services).
Source: Institute for Competitiveness & Prosperity analysis based on data from Ontario Ministry of Finance, *Ontario Economic Accounts: Second Quarter of 2015*, October 2015; Statistics Canada, *Labour force survey estimates (LFS), by sex and age group, seasonally adjusted and unadjusted*, CANSIM Table 282-0087; Statistics Canada, *Consumer Price Index*, CANSIM Table 326-0020; Industry Canada, *Trade Data Online*; University of Toronto, "Post Federal Election Economic Forecasts for Canada and Ontario," *Policy and Economic Analysis Program Memo*, 2015-8.

GDP

During the first and second quarters of 2015, Canada's economy exhibited negative growth and thereby experienced a recession.[1] Ontario's situation was a little better, with first quarter growth flat and second quarter growth at 0.4 percent. Fortunately, the situation has improved with positive growth forecasted for both Canada and Ontario throughout the second half of the year.[2]

Job growth and unemployment

Since August, the unemployment rate in the province has been held relatively stable at around 6.8 to 6.9 percent. In comparison to provincial peers, Ontario's rate is lower than Québec's (7.5 to 7.7 percent), similar to Alberta's (6.5 to 7.0 percent), but higher than British Columbia's (6.2 to 6.3 percent).[3] There have not been any significant gains in employment since August, similar to Québec and Alberta, whereas British Columbia saw improvements in both their participation rate and employment figures.

Inflation

Despite the economy being relatively stagnant, consumer prices rose an astonishing 1.1 percent in the second quarter of 2015 alone. This put pressure on Ontario households. Fortunately, since July, prices have leveled off and are forecasted to remain relatively flat through the remainder of the year.

Trade

Export levels can be subject to seasonal variation, and for this reason the Institute evaluates the province's export performance against Fall 2014.[4] Ontario saw an increase in export value from an average of $19.1 billion per month in Fall 2014, to $21.0 billion per month in Fall 2015. Québec and British Columbia experienced no growth in export value, whereas Alberta experienced a significant reduction from $10.8 billion to $7.5 billion (this is largely attributed to the drop in oil prices). With sluggish economic growth throughout the country, the success of Ontario's firms rests on their ability to continue improving export performance.

RECENT POLICY INITIATIVES

The provincial government has been very active over the past couple of months, following through on some new initiatives proposed in the 2015 Budget. Some of these include building a provincial retirement savings plan, broadening international trade, leveraging public assets, and investing in infrastructure.

Building the Ontario Retirement Pension Plan (ORPP)

Included in the newly elected federal government's platform is a commitment to enhance the Canadian Pension Plan (CPP). However, securing the necessary agreement amongst the provinces to pass the changes is difficult and will take considerable time.[5] In lieu of this, Ontario is paving its own road to retirement security, and announced that it is committed to phasing in the Ontario Retirement Pension Plan (ORPP) beginning January 1st, 2017, with full implementation by 2021.[6]

The ORPP is a mandatory program for all employers who do not offer a sufficient defined benefit or defined contribution retirement plan. Under the ORPP, employers must match employee contributions of 1.9 percent of annual earnings up to $90,000, and the benefit rate is set to be 15 percent.[7] In conjunction with the CPP, Ontarians can expect a combined benefit rate of 40 percent of their income up to $53,600, and 15 percent between $53,600 and $90,000.

While the ORPP is a means to ensure that Ontarians have sufficient financial security for retirement, its design is predicated on the assumption that citizens have an insufficient level of savings – and that this leads to poor living standards in retirement. However, Canadians (and Ontarians) may be saving enough - a recent report found that Canada enjoyed the third lowest rate of elderly poverty among seventeen highly developed countries.[8]

There are four primary concerns with the ORPP:

1. *Reducing wages and employment*: Faced with a 3.8 percent (combined employer and employee contribution) increase in non-wage compensation, employers may freeze or cut salaries; some may even reduce staffing.[9] Reductions in disposable income and weaker hiring may also adversely affect economic growth in the province.

2. *Eroding Ontario's competitiveness*: If the 3.8 percent contribution does not cut into wages, it tacks on an additional cost to businesses. The ORPP would increase the labour costs of all firms forced to contribute to the program with no corresponding productivity

improvement. Relative to other firms within the province, as well as firms in peer jurisdictions, these Ontarian firms may become less cost-competitive and struggle to compete in broader markets.

3. *Overriding individual preferences*: Forced retirement savings plans force individuals to defer spending from their working years into their retirement. This means that recent graduates with student debt, families with young children, and those putting their children through post-secondary education will face additional financial constraints.

4. *Failing to address the "savings problem"*: A recent report found that for every percentage point increase in the total CPP contribution rate, workers' voluntary savings dropped by 0.895 percentage points.[10] It is likely that workers will treat the imposition of the ORPP similarly as they would treat an enhanced CPP. As a result, the ORPP may be ineffective at solving the apparent "savings problem" identified by the Ontario government. At worst, it may just re-shuffle savings from voluntary savings vehicles such as RRSPs or TFSAs, and into the forced government program.

China trade mission

Ontario, like other provinces, is highly reliant on the United States as a destination for its exports. As part of Ontario's broader Going Global Trade Strategy, Premier Wynne has led two successive trade missions to China.

These missions seek to identify and capitalize on new export opportunities for Ontario's businesses, while at the same time encourage Chinese foreign direct investment into the province. As it currently stands, Ontario has a trade deficit with China: the province imports about seventeen times more than it exports to China ($34.1 billion versus $2.1 billion).[11] However, new opportunities have presented themselves through the recent initiatives. Largely focused on opportunities in the science and technology, clean tech, and agricultural sectors, the latest mission to China was a success – over 100 agreements valued at over $2.5 billion were confirmed.[12]

It is imperative that Ontario tap into emerging markets. As places like China and India continue to develop - with forecasted real GDP growth rates of 7 to 8 percent per year in the medium term - shifts in consumer demand present new opportunities for Ontario producers.[13] New demand is likely to arise for Ontario's manufacturing, clean tech, and agricultural products, and these are the industries the province is promoting abroad.

The province is facilitating exports to China in a number of ways:

1. *Engaging with business owners:* The province is developing an online registry that will give companies in Ontario a portal to identify both tariff and non-tariff barriers to trade. The government can then use this information to further assist firms engaged in trade, and rationalize regulations and red tape.

2. *Facilitating agricultural exports:* Ontario's Ministry of Agriculture, Food, and Rural Affairs has established an agri-food trade advisor in Shanghai to assist Ontario's exporting firms.

3. *Reducing the cost of trad*e: Earlier this year, Ontario launched North America's first trading hub for the Renminbi. This removes the need for an intermediate currency conversion to the USD, saving both Ontarian and Chinese businesses millions (if not billions) of dollars.[14]

The Institute's Fourteenth Annual Report highlighted that since the 2008-09 financial crisis, Ontario's export growth has been sluggish. However, as mentioned earlier in this *Report*, over the past year exports have been growing. These types of initiatives are necessary to ensure continuous growth.

Hydro One partial sell-off

To facilitate Ontario's $134 billion push for infrastructure, the province has taken the controversial step of selling partial shares of Hydro One. Most recently, Ontario privatized and sold 15 percent of the company's shares; with an additional 45 percent of shares scheduled to be sold over the next three years.[15]

Hydro One is essentially a natural monopoly, running 97 percent of the province's electricity transmission grid.[16] The main cause of concern for Ontario's households and businesses is not the rates they pay for electricity (since electricity transmission and distribution rates are regulated by the Ontario Energy Board) but the potential adverse effect that the sale of a revenue generating asset will have on the government's financial position.

Using four possible scenarios, Ontario's Financial Accountability Office (FAO) forecasts that the partial sell-off of Hydro One will impact both the government's annual budget balances and level of net debt.[17] Under three of the four scenarios, the FAO forecasts that the partial sell-off will contribute to increasing the government deficit by 2016-17 and every year thereafter.[18] In the most optimistic case, after a few years of gains on the sale, the sell-off will contribute to increasing the deficit by 2019-20 and every year thereafter.[19] Furthermore, the FAO predicts that the cumulative deficits will erode the gains made in the early years and effectively contribute to increasing the province's already massive debt by as early as 2020.[20]

EFFECT OF HYDRO ONE SELL-OFF ON GOVERNMENT FINANCES		
Factor	**Effect on gov. finances**	**Time frame**
One-time tax gain	Positive	Realized at IPO (Nov. 2015)
Lower interest expenses	Positive	Realized every year
Gains on sale (from selling shares)	Positive	Realized 2015/16 to 2018/19
Loss of income	Negative	Realized every year
PILs replaced with Corporate Income Tax	Negative	Realized every year (see note)

Note: PILs are 'Payments in Lieu of taxes'. Provincial Crown Corporations pay PILs which are equivalent to federal and provincial corporate taxes. Because Hydro One is now a private corporation, it will pay corporate income tax, and the province will not receive the federal portion (roughly 60%). This table is not a complete list of all the factors of the sale that affect government finances.
Source: Institute for Competitiveness & Prosperity analysis based on data from Financial Accountability Office of Ontario, "An Assessment of the Financial Impact of the Partial Sale of Hydro One," October 2015.

In response to these criticisms, the province has appealed to the need to fund infrastructure projects. Such investments may increase taxation revenues in Ontario (as a result of higher GDP from the investments) as well as improve labour productivity. However, the province could have funded infrastructure projects by taking on more debt, rather than crediting some of the proceeds from the sale of Hydro One to the Trillium Trust (which is earmarked for infrastructure development).

What good can come of this deal? Aside from potential efficiency enhancements of Hydro One as a result of privatization, the benefits of $3.3 to $5.8 billion of infrastructure must be weighed against the loss of future revenue generation. This is difficult, as assessments on the returns of infrastructure vary and are highly contingent on how, where, when, and in which assets funds are invested. Naturally, this lends us to an analysis of the province's recent infrastructure developments.

Infrastructure developments

For the 2015-16 fiscal year, the province is investing $13.9 billion in infrastructure.[21]

EFFECT OF INFRASTRUCTURE INVESTMENT ON PRODUCTIVITY		
Asset type	**Investment ($ billion)**	**WP22 effect on productivity**
Transit	3.205	Not evaluated
Provincial highways	2.466	Neutral
Other transportation	0.871	Neutral
Hospitals, other health and social	3.286	Positive
Education & training	2.517	Neutral
Justice	0.243	Negative
Other (gov. administration, natural resources, culture and tourism)	1.279	Negative
Total	**13.866**	

Note: Investments include municipal and federal contributions.
Source: Institute for Competitiveness & Prosperity analysis based on data from The Honourable Charles Sousa, Ontario Ministry of Finance, *Building Ontario Up: Progress for Prosperity, Ontario Economic Outlook and Fiscal Review*, November 2015, p.113.

The province's investments are on track with its commitment to invest $134 billion over the next ten years. Because the government is confident that investing in infrastructure will boost productivity, and it cannot justify the sale of Hydro One without this claim, it is worth analysing the investments according to the extent to which these assets actually impact productivity. The Institute's Working Paper 22 found that different infrastructure assets yield positive, neutral, or negative productivity effects for the economy. Of course, there are other benefits of infrastructure that are important, and it is not expected that government would completely abandon investing in certain less-productive assets.

Reassuringly, most of the investments in buildings are strategic: more is being spent on assets that enhance productivity, such as hospitals, and other health and social buildings. Some notable projects include the New Oakville Hospital and the Humber River Regional Hospital, projects valued at $2.7 and $1.75 billion, respectively.[22]

The government is also following through on its push for public transportation. Over $3.2 billion is being invested in this fiscal year alone. Some notable public transportation projects include: the Eglinton Crosstown LRT, Scarborough Subway Extension, and Spadina Subway Extension, projects valued at $5.3 billion, $3.3 billion, and $2.63 billion, respectively.[23]

The significant investment in roadways is, however, a cause of concern and requires careful analysis. Although the Institute identified that investments in roadways have not enhanced productivity on average, it is possible that some projects can yield positive returns. For example, the Highway 407 East Extension (Phase 1) can significantly reduce congestion in the eastern portion of the Greater Toronto Area, enhancing productivity if worker intensity (hours worked) increases and ameliorating commuters' quality of life. Another notable project - the New International Trade Crossing – has more of a direct economic benefit by facilitating trade with Ontario's largest trading partner. In fact, in 2014 Ontario exported four times more ($45.4 billion) to the state of Michigan than it did to its second largest national export market – the UK ($11.7 billion).[24]

Aside from the contribution to growing the province's net debt, and the disruptive nature of some infrastructure projects (such as the Eglinton Crosstown's effect on traffic at rush hour), these investments are likely going to give the economy the nudge it needs.

ONTARIO'S OUTLOOK

Forecasted real GDP growth is positive, exports are growing, unemployment is lower than in recent years, and inflation is likely to settle down. Things are turning around for the province, and there is potential for some growth in the short to medium-term.

The province has commenced its ambitious push for infrastructure as its primary growth strategy. If implemented strategically, Ontario may be able to address its infrastructure deficit, provide both stimulus and a productivity boost to the economy, and hopefully draw in some private investment.

However, with the new $134 billion infrastructure commitment comes a likely increase in the government's already massive debt load. Concerns of sustainability come into question. The province currently pays over $10 billion per year to service the interest on its debt.[25] Standard and Poor's (S&P) recently downgraded the province's credit rating, and interest rates are unlikely to stay this low – both of which will work to increase this substantial cost to the province.[26]

Finally, as Ontario is competing in an increasingly competitive global economy, the province will be adding another non-wage burden on business– the ORPP – creating a wedge between what employers pay their employees and what employees take home as disposable income to spend in the economy. The ORPP appears to be at odds with the province's other initiatives. Which is the higher priority – growing the economy today or preparing Ontarians for retirement? Judging by the province's infrastructure commitment, trade missions, and other initiatives such as creation of the Jobs and Prosperity Fund – Ontario needs to grow today.

The province has made some bold policy decisions, but implementation remains the real challenge. The Institute will continue to follow and comment on these developments as they unfold.

In the next Quarterly Report, Winter 2016, readers can expect an insightful commentary regarding Ontario's new cap-and-trade system, along with other interesting topics and, of course, an update on the state of the provincial economy.

---

[1] University of Toronto, "Post Federal Election Economic Forecasts for Canada and Ontario," *Policy and Economic Analysis Program Memo*, 2015-8.

[2] The Ontario Chamber of Commerce has a positive outlook for the province in the medium-term – with forecasted real GDP growth of 2.6 percent in 2016 and 3.0 percent in 2017. Helmut Pastrick, *Ontario Economic Update 2016,* Ontario Chamber of Commerce, December 2015.

[3] Using seasonally adjusted data for August through November, 2015. Statistics Canada, *Labour force survey estimates (LFS), by sex and age group, seasonally adjusted and unadjusted,* CANSIM Table 282-0087.

[4] Export data is for the months of September and October. Industry Canada, *Trade Data Online,* available online: http://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/Home

[5] Two-thirds of the provinces (seven or more) representing at least two-thirds of the Canadian population must agree before any changes to the CPP can be implemented. There is no guarantee that seven or more provinces will support an enhancement to the CPP. Jeremy Bell, *CPP Enhancement: The Debate Takes Centre Stage,* Plans & Trusts, Volume 33, No. 1, January/February 2015, pages 8-13.

[6] Ontario Ministry of Finance, *ORPP: enrolment schedule,* November 13, 2015, available online: http://www.ontario.ca/page/orpp-enrolment-schedule

[7] Ontario Ministry of Finance, *ORPP: Ontario Retirement Pension Plan,* December 2, 2015, available online: http://www.ontario.ca/page/ontario-retirement-pension-plan

[8] Conference Board of Canada, *How Canada performs: Elderly Poverty,* January 2013, available online: http://www.conferenceboard.ca/hcp/details/society/elderly-poverty.aspx

[9] Benefits Canada, *Canadians prefer TFSAs, RRSPs over CPP expansion,* July 13, 2015, available online: http://www.benefitscanada.com/news/canadians-prefer-tfsas-rrsps-over-cpp-expansion-69286

[10] The total CPP contribution rate is the sum of both the employee and the employer's contribution rates. See: Francois Vaillancourt, Chales Lammam, Ian Herzog and Pouya Ebrahimi, *Compulsory Government Pensions vs. Private Savings: The Effect of Previous Expansion to the CPP,* Fraser Institute, July, 2015, available online: https://www.fraserinstitute.org/sites/default/files/compulsory-government-pensions-vs-private-savings-exec-summary-drupal.pdf

[11] Data is for the year 2014 and is for 'domestic exports', which excludes 're-exports'. Industry Canada, *Trade Data Online,* available online: http://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/Home

[12] Office of the Premier, *Premier's China Mission Generates $2.5 Billion in Agreements: $750 million in Agreements Signed in Beijing,* Government of Ontario, November 13, 2015, available online: https://news.ontario.ca/opo/en/2015/11/premiers-china-mission-generates-25-billion-in-agreements.html

[13] The World Bank, *Global Economic Prospects: Forecast Table,* available online: http://www.worldbank.org/en/publication/global-economic-prospects/summary-table

[14] Ontario Ministry of Finance, *Ontario Home to First Renminbi Trading Hub in the Americas: New Hub to Reduce Costs for Businesses and Boost Trade with China,* Government of Ontario, March 23, 2015, available online: https://news.ontario.ca/mof/en/2015/03/ontario-home-to-first-renminbi-trading-hub-in-the-americas.html

[15] This will reduce the province's ownership to 40 percent.

[16] Financial Accountability Office of Ontario, "An assessment of the Financial Impact of the Partial Sale of Hydro One," October 2015.

[17] *Ibid.* The four scenarios are: High-valuation and cancelling the Debt Retirement Charge (DRC); low-valuation and cancelling the DRC; high-valuation and keeping the DRC; low-valuation and cancelling the DRC.

[18] *Ibid.* What is meant here is that the sell-off will contribute to worsening the government's fiscal situation – whether that be shrinking a surplus or growing a deficit.

[19] *Ibid.*

[20] *Ibid.* Under the four scenarios, the sell-off contributes to increasing the province's debt by 2020, 2025, 2026, or some point (undefined) further in the future.

[21] Of the $13.9 billion investment in infrastructure, $330 million is composed of federal and municipal contributions, while the remaining $13.536 billion will be from the province's coffers. Source: The Honourable Charles Sousa, Ontario Ministry of Finance, *Building Ontario Up: Progress for Prosperity, Ontario Economic Outlook and Fiscal Review,* November 2015, p.113.

[22] Top 100 projects, *Canada's Biggest Infrastructure Projects: Top 100 Projects for 2015,* available online: http://top100projects.ca/2015filters/?rid=&fid=&pid=7&isid=&lid=&oid=&kpid=&yr=2015

[23] *Ibid.*

[24] Industry Canada, *Trade Data Online,* available online: http://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/Home

[25] The Honourable Charles Sousa, Ontario Ministry of Finance, *Building Ontario Up: Progress for Prosperity, Ontario Economic Outlook and Fiscal Review,* November 2015, p.111.

[26] Jane Taber, *Ontario's credit rating downgraded over heavy debt load, budgeting,* The Globe and Mail, July 6, 2015.