

# FISCALAMITY! ONTARIO: FROM HEARTLAND TO HAVE-NOT

Thomas J. Courchene



For the second time in Ontario's history, the province has joined the ranks of the have-not provinces, and the cause both times was soaring energy rents and royalties accruing to the energy-rich provinces. With this as a backdrop, Contributing Writer Thomas Courchene focuses on selected details of Ontario's fiscal position in relation to its sister provinces. He also examines suggestions that the equalization program can be seen as complicating Ontario's fiscal bottom line. The author concludes by presenting a policy blueprint for the province in an era that will likely be characterized by high energy prices and the continuing volatility of the dollar.

Pour la deuxième fois de son histoire, l'Ontario se retrouve parmi les provinces moins nanties. Et cette fois encore, ce recul s'explique par les rentes et redevances tirées des ressources naturelles qu'ont accumulées les provinces riches en énergie. Dans ce contexte, notre collaborateur Thomas Courchene fait le point sur quelques aspects clés de la situation financière de l'Ontario par rapport à celle de ses provinces sœurs. Il examine aussi les hypothèses selon lesquelles le programme de péréquation vient compliquer cette situation. Il propose enfin pour la province un plan d'action adapté à une époque qui sera vraisemblablement caractérisée par des prix de l'énergie élevés et une instabilité permanente.

The Ontario of Frost and Robarts and Davis was Canada's economic heartland. The province was so prosperous, so diversified economically and so powerful politically that Canadian policy had little choice but to be cast in a pro-Ontario light. In effect the old saw "What is good for General Motors is good for America" was even more relevant for the Ontario-Canada relationship because the latter was reciprocal. Since heartland Ontario could generally count on Ottawa to further the province's interest, it was in favour of a strong central government. And Ottawa delivered the Seaway, nuclear power for Ontario Hydro, the Auto-pact, the National Energy Program and so on. As a result, more so than their fellow citizens in other provinces, Ontarians are unhyphenated Canadians, although this may have less to do with fealty than with the crass reality that Ontarians often elect two governments — their own and Canada's — so why not like them both.

Not surprisingly, Ontario's "king of the hill" status did not elicit much sympathy for its concerns from its sister provinces. No one expressed this more creatively, yet tellingly, than Newfoundland Premier Joey Smallwood. Speaking at the 1967 Confederation of Tomorrow conference, Smallwood noted:

*I notice that Premier Frost is here today and I remember his saying when he was in office as the Premier of*

*this great province at a Dominion-Provincial Conference, saying something like this. He said, "You have all read that we have three thousand new industries come to Ontario since the war." (This was about ten years after the war. They already had three thousand new industries.) He said, "You think this is wonderful, don't you?" — looking at the nine of us, the other premiers. "You think this is wonderful. You don't realize the other side of it, all the new schools we have to build and all of the housing and all of the hospitals and all the new roads and paving and everything else." I said, "Stop, you are breaking my heart."*

Yet heartland Ontario did recognize its privileged position and did attempt to play an integrating role in the federation. For example, Premier John Robarts magnanimously orchestrated the aforementioned 1967 Confederation of Tomorrow conference in order to (in Jean-Luc Pepin's words) "give Danny [Quebec Premier Daniel Johnson] the biggest soap box in Canada to tell the people of the country what he really wanted for his province."

Moreover, Ontario MPs often tended to view themselves as national rather than Ontario parliamentarians, much to the chagrin of Ontario premiers Rae, Harris, Eves and McGuinty, as noted below. But even here, one might

note that supporting the interests of other parts of the country was not necessarily inconsistent with advancing Ontario's own interests: a comprehensive system of equalization payments would eventually benefit Ontario as the principal east-west supplier/distributor of manufactured goods, both domestic and imported

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But the Ontario of Davis remained too proud (heartland was still alive, even if not well) to receive equalization payments. So Premier Davis, not unlike Premier Dalton McGuinty today, took the position that if Ontario qualified for equalization this must mean that there was something seriously awry with the equalization formula. Accordingly Davis supported the passage in the House of Commons in 1981 of what was referred to as the "personal income override." The express purpose of this legislation was to strip Ontario, retroactively, of its equalization entitlements. The essence of the personal income override was that no province would be eligible for equalization payments if its per capita personal income exceeded the national average per capita personal income in the current year and the previous two years. While this is written in general terms, its specific and only target was Ontario. (Intriguingly, if this legis-

lation were still in play today, it would again exclude Ontario from receiving equalization, because Ontario's personal income is still above the national average since energy royalties accrue directly to provincial governments and, therefore, do not enter personal income.)

In return for agreeing to forgo equalization payments, Ontario requested a reworking of the equalization formula and proffered several options, including a proposal that

would have Ottawa equalize only non-resource revenues and would have the provinces embark on an interprovincial revenue-sharing pool for resource revenues.

**A**s I can attest after advancing this proposal on several recent occasions, this is a tough sell at the best of times, but it was impossible in the time frame of the National Energy Program, which came into being with the blessing of the Davis government. Ottawa's initial proposal for reworking equalization was an "Ontario standard" — this would bring all have-not provinces up to Ontario's level but would not break the federal bank because Ontario had no energy revenues to equalize. The compromise was the "five-province" standard, which essentially accomplished the same thing, namely that Alberta and the Atlantic provinces were excluded so that Ottawa's twin goals were still satisfied — the fossil energy influence on equalization would be substantially muted and Ontario would again become a have province.

**W**ith President Reagan's "military Keynesianism" (military spend-

ing and tax cuts) and the resulting depreciation of the Canadian dollar (relative to the US dollar), Ontario embarked upon an impressive export-led boom and soon forgot about any energy/equalization concerns. This was obviously influenced by the collapse in global energy prices and the advent of the FTA (which Ontario's Peterson government opposed in spite of the fact that Ontario business was onside because it wanted, *inter alia*, to "lock in" the earlier and dramatic export penetration of US markets). The FTA and later NAFTA provided the backdrop for Premier Mike Harris's launching of Ontario as a "North American region state," which, I would argue, formally spelled the end of heartland.

In the interim, and foreshadowing Dalton McGuinty's ongoing list of grievances against Ottawa, Ontario's next reality check came first with the Bank of Canada's 1988 policy of price stability as its operating strategy (replete with a damaging transition period of high interest rates, a soaring currency and sharply deteriorating economic and fiscal fortunes) and then with the early 1990s global recession. This was the context for the call by Premier Bob Rae (1990-95) for "fair-shares federalism," based on a series of position papers prepared by Informetrica. What is rather surprising is that these fairness issues, which became the rallying cry of successive Ontario premiers through to McGuinty, were met with stonewalling by successive prime ministers (Mulroney, Chrétien, Martin and even Harper). In terms of the impact on Ontario's fiscal position, the most serious of Rae's concerns was the 5 percent growth cap on the Canada Assistance Plan for Ontario, Alberta and BC. This "cap on CAP" cost Ontario nearly \$10 billion before CAP was folded into the CHST in the 1995 budget and then promptly reduced by one-third. Paul Martin's generous health care and equalization decade-

long agreements in fall 2004 will largely restore these cuts in cash transfers. In a related move, however, Ontario argued for equal-per-capita values for the non-equalization federal-provincial cash transfers, a request that was finally granted in the 2007 federal budget for the social transfers and will take effect in fiscal year 2014-15 for the Canada Health Transfer.

In several other areas, however, the perceived inequities as of the early 1990s still exist: Ontario's share of labour market and training funds was, and still is, well below its population or unemployment share (in 2006, unemployed Ontarians accounted for 39 percent of Canada's unemployed, but received only 27 percent of the national funding under the training component of EI); the EI provisions discriminate against Ontario in terms of both eligibility requirements and length of benefits, an issue that returned to the headlines recently when it was revealed that only 22 percent of Toronto's unemployed qualified for EI benefits, compared to nearly 50 percent in selected other major cities; and Ontario finally signed an agreement with the Martin government that only partially addressed the long standing underfunding of immigration-settlement for Ontario.

What is surprising is that the Chrétien/Martin governments, at times with two-thirds of their caucus composed of Ontario MPs, held out so long against McGuinty's fiscal imbalance claims. It was only when McGuinty's arguments began to find traction among Ontarians that Liberal Ottawa made some concessions. If Ontario MPs are impervious to documented concerns from their own province, even when their government is of the same political stripe, then one can only conclude that some aspects of heartland still survive.

By way of a final comment here, while the Harper government has

addressed some of Ontario's fiscal concerns, its response has arguably been more than offset by its opening up some disconcerting issues on the political front, including a proposal to redress the House of Commons representation shortfall for British Columbia and Alberta, but not for Ontario.

This is the historical backdrop to the remainder of this article, which addresses Ontario's descent into "fiscal calamity." The analysis will be informed by two developments. The first is the advent of \$100-plus oil (with "oil" as a catch-all for all fossil fuels) and the second is the rather unprece-

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dent public berating of Ontario's policies by the former Ontario treasurer and now federal finance minister Jim Flaherty — in particular, Flaherty's claim that Ontario is causing its own economic troubles by not reducing its income tax rates. By way of an intriguing aside, while the polls suggest that this berating of Ontario may not be playing well in Ontario for the federal Conservatives, presumably the longer-term political rationale is that, during the eventual federal election, Ontario's poor economic performance can be

laid at the feet of the McGuinty Liberals in an "I told you so" manner.

Politics aside, these two developments are interrelated in that it will be argued that one of the key reasons why Ontario cannot reduce its income taxes relates to \$100 oil and the operations of the east-west transfer system, including equalization. My thesis is that Ontario's economic and fiscal relationship with the federation is such that, first, the province is arguably not able, fiscally, to match the income tax rates in most other provinces, and that, second, reducing income taxes is, in any event, not its primary economic challenge.

A convenient starting point for addressing this assertion is to focus on Ontario's revenues relative to those of its sister provinces. Toward this end, the consolidated provincial and local revenues per capita appear as row 1 of table 1. These are actual revenues and they include own-source revenues, federal cash transfers (equalization and CHT/CST), investment income, sales of goods and services, etc. What is surprising is that Ontario's per capita revenues are so far below those of the other provinces. At the most general of levels, this has to be because of one or more of the following: cash transfers to the poorer provinces; energy revenues for Newfoundland and the three westernmost provinces; low tax rates for the high-personal-income provinces (e.g., Ontario and British Columbia). The role that federal cash transfers play in all of this can be seen by comparing row 1 with row 2, which presents provincial own-source revenues (excluding cash transfers). Here, Ontario is in the middle of the pack, well behind the energy provinces and Quebec (which is the province with the highest tax rates), but above the Maritimes and Manitoba. And when the comparison is only on terms of personal income taxes (row 3), then Ontario is second only to Alberta but, perhaps, about to decline.



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MATIÈRE À RÉFLEXION :

« ON ESTIME QUE LES ÉMISSIONS  
DE GAZ À EFFET DE SERRE RÉSULTANT  
DE LA DÉFORESTATION CORRESPONDENT  
À PLUS DE 18 % DES ÉMISSIONS  
TOTALES DE GES. »

*Rapport Stern sur les changements climatiques, octobre 2006*

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Compte tenu d'un taux de déforestation virtuellement nul et de plus de forêts vierges, de forêts certifiées et de forêts protégées que tout autre pays, le Canada est un chef de file de l'aménagement forestier durable depuis un certain temps déjà. L'industrie canadienne des produits forestiers s'engage à l'amélioration continue et elle souscrit à cette déclaration du Groupe d'experts intergouvernemental sur l'évolution du climat : « À long terme, la stratégie d'aménagement forestier durable qui vise le maintien ou l'augmentation des stocks de carbone en forêt, tout en assurant un rendement annuel soutenu en bois, sera la plus avantageuse en termes d'atténuation continue. »

Il est temps que le reste du monde suive  
l'exemple du Canada dans l'aménagement durable  
des forêts — le climat de la planète en dépend.



Association des produits  
forestiers du Canada  
**fpac.ca**

While Ontario's overall per capita revenues may be surprisingly low, they are lower still in terms of the underlying rationale for equalization. Section 36(2) of the *Constitution Act, 1982* states that equalization payments should ensure that "the provinces have sufficient revenues to

tion and for health/social services. The row 1 values are then divided by this index, with the results labelled "effective revenues," presented in row 5. Row 6 then expresses these effective revenues as an index (again with Ontario = 1.00). Ontario is now by far the "poorest" province. Second-place

ber of bundles per capita? Perhaps Ontario requires the fewest bundles, in which case having the lowest effective per capita revenues is, for present purposes, just fine. My hunch is that this is not true, for at least two reasons. First, many of the traditional have-not provinces are, compared to Ontario, significant positive net recipients of regionally privileged EI benefits, which in turn limits the draw on their respective provincial welfare budgets. Second, it very much seems to be the case that Ontario's immigrant settlement expenditures as

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provide reasonably comparable levels of public services at reasonably comparable levels of taxation." Assuming for the moment that provinces have identical needs for public services, what level of revenues across provinces would be sufficient? Given that much of government spending is related in one way or another to wages in each province, row 4 of table 1 presents an index of wage costs across provinces (with Ontario = 1.00), where the underlying data are a simple average of average weekly wages in each province for public administra-

British Columbia can provide 14 percent more standardized "bundles" of public services than can Ontario (with a conceptual bundle being a weighted average of the cost various types of services: civil servants, teachers, police officers, rents, welfare payments, medical procedures and so on). Next-in-line Nova Scotia can produce 21 percent more bundles, and so on through to Newfoundland/Labrador and Alberta, with a 68 percent and 61 percent advantage respectively.

This begs the obvious question: do all provinces require an identical num-

ber of bundles per capita? Perhaps Ontario requires the fewest bundles, in which case having the lowest effective per capita revenues is, for present purposes, just fine. My hunch is that this is not true, for at least two reasons. First, many of the traditional have-not provinces are, compared to Ontario, significant positive net recipients of regionally privileged EI benefits, which in turn limits the draw on their respective provincial welfare budgets. Second, it very much seems to be the case that Ontario's immigrant settlement expenditures as well as the various costs of urban congestion will offset any presumed advantages of economies of scale that may attach to Ontario.

Hence an initial assessment of one of the themes of this essay is that Ontario's income taxes are relatively high because the province is revenue-challenged relative to its sister provinces. (That the province could reduce income taxes and increase consumption taxes is obviously possible and even desirable and will be dealt with later, but this is a different issue.)

TABLE 1. FISCAL ONTARIO IN COMPARATIVE CONTEXT

	NL	PEI	NS	NB	QUE	ONT	MAN	SASK	ALTA	BC	Total
1. Total revenues <sup>1</sup> (2007) (\$/capita)	11,520	10,022	9,079	9,755	10,602	8,155	9,424	10,416	11,942	9,138	9,614
2. Own-source revenues (\$/capita)	7,110	6,270	6,478	6,494	8,304 <sup>3</sup>	6,922	6,876	8,710	10,995	7,728	7,801 <sup>3</sup>
3. Personal income taxes (\$/Capita)	2,273	1,797	2,281	1,883	2,817 <sup>3</sup>	2,783	2,085	2,369	3,214	2,020	2,650 <sup>3</sup>
4. Average weekly earnings <sup>2</sup> index (Ontario = 1.00)	0.84	0.93	0.92	0.95	0.93	1.00	0.81	0.89	0.91	0.98	
5. Effective revenues (row 1) ÷ (row 4)	13,714	10,776	9,868	10,268	11,400	8,155	11,635	11,703	13,123	9,324	
6. Effective revenues index (Ontario = 1.00)	1.68	1.32	1.21	1.26	1.40	1.00	1.43	1.44	1.61	1.14	
7. National average fiscal capacities (2006-07) (\$/capita)	6,020	4,506	5,461	4,885	5,962	7,053	5,228	7,340	13,042	7,669	7,317
8. O'Brien fiscal capacities (2006-07) (\$/capita)	5,402	4,503	5,301	4,759	5,803	7,002	5,127	6,476	11,617	7,176	6,953

Notes:

<sup>1</sup> Includes own-source revenues plus federal cash transfers (Statistics Canada, CANSIM table 385-0001).

<sup>2</sup> This is an average of weekly earnings in public administration and health/social services (Statistics Canada, cat. No. 72-002 XIB).

<sup>3</sup> An adjustment of \$3.7 billion has been made to account for the Quebec abatement.

As prelude to the implications of Ontario becoming a have-not province. I now turn to some of the details of the equalization formula. Row 7 of table 1 presents estimates of per capita fiscal capacity for fiscal year 2006-07 (the latest year for which data are available), with these fiscal capacities based on the full national average standard (NAS): 100 percent of all provincial revenues enter the formula. Ontario would easily qualify for equalization were the NAS in play, since its per capita fiscal capacity of \$7,053 is below the NAS value of \$7,317. However, the equalization program in place is the so-called O'Brien formula, where only 50 percent of resource revenues enter the formula. Per capita fiscal capacities for 2006-07 under the O'Brien formula appear as row 8 in table 1. With a fiscal capacity of \$7,002 per capita and with the equalization standard equal to \$6,953, Ontario remains a "have" province by \$49 per capita. However, since current energy prices have risen significantly since 2006 (the base for the 2006-07 energy revenues) and since Ontario's relative growth has fallen, there can be little doubt that Ontario has now donned the mantle of our newest have-not province.

What happens then? Suppose that, from a position where Ontario is a have-not province, energy revenues increase by a further \$1 billion (i.e., almost 5 percent of overall resource revenues). This will mean that \$500 million will enter the O'Brien formula. Focusing only on the six provinces that will clearly qualify for equalization (Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Ontario and Manitoba) and temporarily excluding Saskatchewan and Newfoundland and Labrador (see below), the population share of these equalization receiving provinces is 71 percent while their share of the resource revenue base is 18 percent. Equalization will rise by the excess of their population share over

their base share, multiplied by the \$500 million: therefore by \$265 million, with Ontario receiving roughly \$170 million of this total. Given that Ontario residents account for, say, 40 percent of Ottawa's revenues, Ontarians will be saddled with \$106 million of the \$265-million increase in equalization. This is the essence of McGuinty's "churning" issue: namely, that the bulk of any equalization payments that the province receives will come out of the pockets of its own citizens. This cannot be efficient.

But McGuinty has a lot more to worry about than this. There is a cap on equalization in the O'Brien formula: no province can receive equalization if its all-in per capita revenues exceed those of the lowest of the have provinces. It was assumed that Ontario would provide the cap, and it was Ontario that insisted that there be a cap. To this point it was assumed that the Ontario cap was binding on Saskatchewan and Newfoundland. However, now that Ontario is a have-not province, the "capping province" becomes British Columbia. This has very significant consequences. As seen in row 7 of table

be realized: Ontario residents will be footing a major part of this \$1.15 billion increase in equalization going to provinces that already have revenues well in excess of Ontario's.

While the reality that Ontario would become an equalization-receiving province has garnered national attention and, as the title of this essay suggests, merits the label "fiscalamity," a much more meritorious recipient of the label is Finance Canada. The cost of the equalization program in 2004 was in the \$9-billion range. With skyrocketing energy revenues and with Ontario in the ranks of the have-nots, the equalization bill could easily be in the \$15-billion range. Thus, to the extent that equalization is now a fiscal problem, it is largely Flaherty's problem and it may very well spell the end of the O'Brien formula adopted only 15 months ago.

Attention is now directed to the manner in which the equalization program interacts with the pattern of revenues across provinces (row 1 of table 1). The message will be that the internal mechanics of the equalization pro-

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1, the equalization cap increases by over \$600 per capita — from Ontario's \$7,053 to British Columbia's \$7,669. This allows Saskatchewan an additional \$329 per capita in equalization and Newfoundland a whopping \$1,649 per capita. In dollar terms, this amounts to a potential \$1.15 billion increase in equalization, most of which would be immediately realized, with Ontario taxpayers on the hook for something like an additional \$450 million. To be sure, this is a one-shot (although permanent) increase in equalization. The result of this is that McGuinty's worst fears will

program provide a further reason why provinces with a lower fiscal capacity than Ontario can leapfrog the province and end up with higher revenues. For example, the methodology for calculating Ontario's per capita fiscal capacity for the income tax base leads to Ontario having 112 percent of the all-province average, whereas its actual per capita collections are only 107 percent of the national average (calculated from row 3 of table 1). This serves to increase equalization for the traditional have-not provinces and, therefore, allows them to acquire more overall per



CP Photo

Ontario Premier Dalton McGuinty leads a province that was once Canada's proud economic heartland, but now risks being a have-not province in terms of Canada's equalization formula. He wants a new deal, one that's fairer to Ontario, and Tom Courchene writes that he's got a very strong case.

capita revenues associated with the income tax than Ontario itself has. This is even more the case for the property taxes, where the methodology selected for calculating fiscal capacities again allows equalization-receiving provinces to have larger property tax revenues than does Ontario. This is the fiscal version of double jeopardy. To ignore differences in the wage costs across provinces (i.e., to ignore capitalization) in terms of the equalization formula (as highlighted earlier), but then to allow prices or capitalization to augment the tax bases in richer provinces, serves to increase equalization on both counts and, other things being equal, allows the traditional have-not provinces to acquire *actual* overall per capita rev-

enues in excess of those of Ontario. This may have been viewed as equitable under heartland Ontario when trade flowed east-west behind tariff walls, but now it compromises Ontario's north-south competitiveness in tariff-free NATFA economic space.

**T**he above equalization concerns notwithstanding, Ontario's longest-standing issue with equalization, one that was central for Premier Davis, is that there is a serious funding inequity associated with equalizing energy rents. The issue is actually rather straightforward in principle but an absolute minefield politically. Energy rents/royalties are escalating and in the process they are driving up equalization. Ottawa cannot

access these rents. Rather, Ottawa must finance the resulting equalization increase out of its general revenues, of which roughly 40 percent (perhaps somewhat less recently) will come from Ontario taxpayers. To be sure, the overall operations of the energy sector do deliver substantial tax revenues to all provinces and to Ottawa, but so do the operations of the banking and auto industries located in central Canada. Energy rents/royalties are entirely different, accruing as they do, free from tax by Ottawa, into provincial coffers. At current energy prices McGuinty is justified in focusing on the funding inequity, especially since Ontario will likely be somehow denied (again) the receipt of equalization payments.

Solutions that are politically acceptable, as noted, are hard to come by. The interprovincial revenue-sharing pool referred to above would pass the equity test but would likely founder politically because the energy provinces would actually be transferring, say, 20 percent of their energy revenues to the sharing pool (with all provinces drawing out

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their population share). A variant that gets around this feature would be to "revenue-test" all of Ottawa's non-equalization cash transfers. In more detail, Ottawa would equalize all non-resource revenues to the national average standard. Then the federal CHT and CST cash transfers would decrease by, say, 20 cents for every dollar that a province's revenues exceed some designated threshold, say, 105 percent of the national average of all-in revenues. Ottawa could then return its savings via an equivalent tax transfer to the provinces. We income-test almost every other program (OAS, GIS, EI benefits, the child tax benefit), so why not equalization? While I made a similar recommendation in a previous *Policy Options* article, ideas along these lines may have more traction now that Ottawa will be taking much more interest in the funding of the program, given its looming liability.

Complicating all of the above discussion for Ontario is the fact that energy prices are having a major economic impact well beyond the equalization formula. This arises because the energy provinces tend to bring their energy revenues directly into their annual budgets. This has at least two significant implications.

The first is that Alberta, for example, has utilized its energy rents to become the lowest-tax-rate jurisdiction in North America, not just Canada. In turn, this creates a significant tax wedge between Alberta and the non-energy provinces, which not only reduces Ontario's relative competitive advantage but also adds fuel

to the claim that Ontario's income tax rates are too high.

The second is far more significant, at least in the current time frame, because it is serving to frustrate, if not severely impair, Ontario's chosen role as a North American cross-border region state. Whereas Norway re-deposits its revenues from energy exports back into international capital markets, thereby ameliorating the upward pressure on the Norwegian krone, the international inflows of funds from energy exports and investments in the energy patch are typically taken directly into provincial budgets (or in any event not re-deposited internationally) and have resulted in a rapid and dramatic appreciation of the Canadian dollar — from the low-60-cent range early in the new century to nearly 110 cents, before settling near parity at the time of writing. The amplitude (60 percent from trough to peak) has effectively priced many goods out of US markets and, arguably, unwound a significant amount of the Ontario manufacturing infrastructure that was accumulated over the decades in Ontario.

This is part of the double whammy to Ontario's cross-border trade. On the one hand, the US homeland secu-

rity concern has thickened the physical border and jeopardized just-in-time cross-border production and, on the other, the appreciation has thickened the economic border. This latter effect relates as much to the utter volatility of the exchange rate as it does to the actual level, with the result that foreign investment in the Canadian economy with the intention of producing for the North American market may well be scared away by exchange-rate uncertainty.

The reaction of the mainstream economics profession is, almost unanimously, to fall four-square behind the Bank of Canada's inflation-targeting

policy and to ignore the exchange rate volatility. To be sure, there is some sympathy for the demise of manufacturing, but not much, because it was destined to gradually erode in any event. I believe this to be a major analytical error on the part of my profession. Energy prices are driving an economic wedge between the energy sector and the rest of Canada. This cannot be avoided. But to allow the currency to shoot skyward is to add an additional absolute and relative blow to the centre. This is a north-south solution to an east-west problem. While we may hope that Alberta will shelter its increasing rents in heritage-type funds invested in international markets, Alberta should not be expected to follow the Norway solution. This being the case, the way forward for Canada should be some version of a fixed Canada-US exchange rate with a common currency as the longer-term goal (*Policy Options*, February 2008).

What vision emerges for the Ontario of tomorrow from this *tour d'horizon* of the province's political, fiscal and economic relationship within Canada and North America? On the political front, once whatever psychological impact from joining

the ranks of the equalization-receiving provinces is absorbed by Ontario and Ontarians, my hunch is that this will turn out to be a liberating experience. Ontario will become much freer to pursue its own interests and to wield its significant electoral power in the federation. And in doing so it will find more support than hitherto from its federal MPs. But toward what end? An assessment of the province's various assets and opportunities would seem to point in the direction of deepening its capital — physical, financial, institutional and especially human. In terms of the latter, Ontario needs to reorient its entire social infrastructure (education, training, post-secondary education, research institutes, welfare, medicare, etc.) toward being more flexible and efficient and more geared toward skills and human capital formation, all with the view of ensuring that the social infrastructure becomes a platform for skills development, innovation and entrepreneurship. Toward this end the province will need to recast some of the existing federal programs so that they become consistent with this underlying vision of a (trite admittedly) “North America headland.”

For example, much of the EI program, with its rewards for short term-labour force attachment, is antithetical to a human-capital-based economy. If this cannot be altered, Ontario should seriously consider pulling its broader public sector out of the federal EI (as I understand it has the right to do) and creating an Ontario version that will embrace skills enhancement. Moreover, meaningful pursuit of a knowledge economy requires a complementary immigration program. Again, failing changes by Ottawa in this direction, Ontario has the constitutional right to mount its own policy that could, following Australia, privilege visa students in terms of immigra-

tion as part of an effort to create world-class universities. Health care is emerging not only as a major employer of high-level talent but, as well, as a sector with many and varied commercial applications. Nothing prevents Ontario from introducing internal markets into medicare along the *Canada Health Act*-compatible models proposed by Senators Kirby and Keon.

On the institutional front, the province needs to privilege the Greater Toronto Area (GTA) and other major cities. These cities are the repositories of dense concentrations of knowledge and talent that are essential to sustain the expertise in financial, business and research services that lead our export penetration of NAFTA economic space and beyond. Specifically, the province needs to remedy the Canadian reality that the GTA, for example, is fiscally and institutionally/constitutionally weak in an international comparative context, and even with respect to US major cities.

**Ontario needs to reorient its entire social infrastructure (education, training, post-secondary education, research institutes, welfare, medicare, etc.) toward being more flexible and efficient and more geared toward skills and human capital formation, all with the view of ensuring that the social infrastructure becomes a platform for skills development, innovation and entrepreneurship. Toward this end the province will need to recast some of the existing federal programs so that they become consistent with this underlying vision of a (trite admittedly) “North America headland.”**

This is problematic given that cities are deemed to be the new and dynamic motors in this information age.

On the economic front, Ontario needs to deepen its physical capital infrastructure. Actually, the high dollar will help here because it provides an incentive to increase the capital-labour ratio. This will allow Ontario to compete with the upper levels of its labour force and in higher-value-added products that will be less sensitive to a volatile dollar, if that remains our fate. Here, Finance Minister Flaherty is correct — Ontario does need lower income taxes.

But the way to do this is to convert the PST into a GST. This will enhance export competitiveness because the GST on exports will be rebated. As important, this will pave the way for a tax shift away from income and toward consumption, namely by reducing income taxes and especially corporate taxes and raising the provincial GST.

Finally, but hardly exhaustively, the province must be forward-looking. By way of an example that links up with the earlier analysis, if we are going to put a price on carbon, then the province should favour a consumer-based carbon tax rather than an origin-based emissions tax. The revenues from the former will accrue across the country, which Ottawa can then share with provinces (perhaps along the lines of the harmonized sales tax). However, an origin-based emissions tax would presumably accrue largely to the energy provinces, so that these provinces will

be reaping not only energy royalties but as well the returns from carbon abatement. How long will it be before pressures will develop to equalize these emissions tax revenues, with Ontario again paying nearly 40 percent of the cost of the equalization? Haven't we been there before?

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