



# Ontario's Competitiveness Challenge: An Agenda for Change

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# Executive Summary

- Ontario has a serious competitiveness challenge and it is getting worse. The decline in competitiveness has been documented by various national and international organizations. Failure to address this challenge threatens Ontario's long-term prosperity.
- The sources of our declining competitiveness are complex and multifaceted – including high taxes, the regulatory burden on business, infrastructure delays and inefficient business approval processes.
- In this essay we focus our attention on the regulatory burden on business and suggest policy strategies to help limit the proliferation of new regulations and streamline the most burdensome existing regulations.
- To stop the proliferation of new regulations, we recommend an intelligent application of a 2-for-1 (TFO) rule to apply to new regulations, a separate challenge function within government focused on managing and minimizing the regulatory burden, and better use of stakeholder consultations.
- To streamline existing regulations, we recommend an 80-20 rule approach, by which we mean that policymakers ought to focus on a targeted subset of the regulatory burden that is disproportionately costly and problematic. Inviting firms to identify a small number of the most burdensome regulations and reforming those should make the process manageable and focused on where reform will have the greatest impact.
- Finally, we recommend adopting a one-window approach for business approvals, together with a lean approval process, and clear services standards.

# I. Introduction

Ontario has a serious competitiveness challenge and it is getting worse. The warnings of senior business leaders and various policy commentators over the past few years have so far been largely ignored. Failure to address this challenge threatens Ontario's long-term prosperity.

While Ontario holds many attractions for entrepreneurs and business investment – political stability, a well-educated workforce, good infrastructure, and so on – policymakers have, in recent years, taken its business competitiveness for granted. Much political and media attention has been directed to the vibrancy of the high-tech sector. But not all sectors of Ontario's economy have similarly grown and prospered in recent years. Manufacturing and other industries in Ontario have been losing ground to competitors in other jurisdictions, especially in the critical United States market.

Economic commentators have pointed out some recent signs of malaise. Non-residential business investment has been sluggish and has lagged that of other economies in the Organisation for Economic Co-operation and Development (OECD). Ontario firms have been investing more funds outside the country than foreign firms have been investing in Ontario. Exports have been growing slowly. Lengthy delays have hampered project approvals in energy and non-energy sectors alike. Business confidence, as measured by industry association surveys, has flagged.

The underlying problems plaguing Ontario's competitiveness are wide-ranging. They include (but are not limited to): high personal and corporate tax rates, a considerable regulatory burden on business, high energy costs, infrastructure delays, and inefficient business approval processes. High marginal tax rates on middle- to high-income earners, including entrepreneurs, have discouraged investment and innovation – at least in areas outside technology (where federal and provincial financial support plays an important role). This situation has worsened with the recent sharp reductions in U.S. federal personal tax rates. On the corporate tax front, recent U.S. changes have eliminated the corporate tax advantage Canada once enjoyed.

An increase in personal income tax rates for high-income earners is part of a broader emphasis on equity over economic efficiency in provincial policy. A growing regulatory burden is also part of this trend. According to the Canadian Federation of independent Business (CFIB), Ontario's regulatory cost burden is the highest among all the provinces.<sup>2</sup> Despite efforts over the past few years to reduce administrative burden, Ontario has continued to

<sup>2</sup> CFIB, Canada's Red Tape Report for 2015, see Table B.2. ([https://www.cfib-fcci.ca/sites/default/files/2018-01/2018-Red-Tape-Report-Card\\_0.pdf](https://www.cfib-fcci.ca/sites/default/files/2018-01/2018-Red-Tape-Report-Card_0.pdf)).

receive poor grades from the CFIB on its progress in reducing red tape.<sup>3</sup>

These are merely two examples where Ontario's public policy has contributed to an erosion of the province's relative economic competitiveness. There are various others. Together, they are a sign that a pro-competitiveness agenda will need to be holistic.

What can be done then to restore the competitiveness of the economy in Ontario? There is no shortage of ideas. Many commentators, especially those directly affected in the business sector, have offered their views on how to improve competitiveness. What is needed is a coherent and robust agenda for change that addresses the true underlying problems that, if left unaddressed, will continue to cause the erosion of Ontario's long-term competitiveness and prosperity.

<sup>3</sup> See, for example, CFIB's Red Tape Report Card for 2018, page 5.

## II. Causes of Ontario's Competitiveness Challenge

Ontario's competitiveness refers to its ability to successfully produce and sell its products elsewhere in Canada, in the U.S., and in international markets.<sup>4</sup> Needless to say, competitiveness in the U.S. market, in particular, is absolutely critical to Ontario. About 80 percent of Ontario's exports are sold to the U.S.

Ontario's competitiveness in manufacturing, a crucial component of its economy, has been eroding for some time. In fact, recent empirical work by the Bank of Canada shows that market shares in the U.S. for Canada's non-energy goods have been declining over the past 15 years. As Bank of Canada senior deputy governor Carolyn Wilkins pointed out in a recent speech,<sup>5</sup> "the effect has been particularly acute in the manufacturing sector. The trend has meant a much lower share of employment for most manufacturing industries, including automotive and parts, and clothing."

The Bank's analysis shows that Canada continued to lose non-energy market share in the U.S. over the 2014-17 period.<sup>6</sup> Moreover, almost two-thirds of the loss of market share between 2003 and 2017 can be attributed to two sectors: motor vehicles and parts, and forestry products, building and packaging materials. Most

of the loss in market share in motor vehicles (excluding parts) can be explained by Mexico's gains in the U.S. This is directly relevant to Ontario, since motor vehicles and parts are Ontario's largest export.

While the manufacturing sector accounts for about 12 percent of Ontario's economy, it accounts for about 80 percent of the value of Ontario's total exports. About 70 percent of the value of Ontario's total exports is manufacturing exports to the U.S.<sup>7</sup> The Bank of Canada's analysis suggests that a major factor in the loss of competitiveness in manufacturing is high relative unit labour costs. Economists often focus on relative unit labour costs of production when comparing the competitiveness of different jurisdictions in manufacturing. But an important consideration is the strength or weakness of the currency when making these comparisons. A weaker Canadian dollar can reduce the U.S. dollar cost of

<sup>4</sup>Michael Porter, *The Competitive Advantage of Nations* (Free Press, 1990: New York, N.Y.), highlighted the importance of competitive advantage for the performance of economies (as well as of firms and industries).

<sup>5</sup>Carolyn Wilkins, "An Update on Canada's Economic Resilience," September 6, 2018. Based on 2017 data from Innovation, Science and Economic Development Canada's Trade Data Online, extracted on September 30, 2018.

<sup>6</sup>N. Labelle St-Pierre, "Decomposing Canada's Market Shares: An Update," Bank of Canada Staff Analytical Note No. 2018-26 (August 2018).

<sup>7</sup>Based on 2017 data from Innovation, Science and Economic Development Canada's Trade Data Online, extracted on September 30, 2018.

production of Ontario-manufactured products. This is not a crutch that manufacturers should count on, however, as we have seen in the past when high oil prices pushed the Canadian dollar up. In fact, the Bank's analysis noted that Canada's loss of market share between 2014 and 2017 in U.S. imports of non-energy goods occurred despite the depreciation of the Canadian dollar.

The traditional perspective is that improving competitiveness usually involves finding ways of reducing relative costs and/or improving the quality of products. Reducing unit labour costs is equivalent to improving labour productivity. Better labour quality (i.e., better job-related skills), more business investment, and improvements in technology (innovation) are among the usual prescriptions.

## Taxation

Ontario's combined top federal-provincial marginal personal tax rate, important to investors, business owners and entrepreneurs, is now above 50 percent, when Ontario surtaxes are taken into account.

This top rate comes into effect at a taxable income of \$220,000 (in 2018). After recent U.S. reforms, the top U.S. federal-state marginal tax rate is about 38 percent in nearby Michigan, and top marginal rates come into effect at \$500,000 USD. This disadvantage in top personal tax rates affects incentives for entrepreneurs to invest, to locate in Ontario and to attract highly skilled employees.

Government policies, however, also play an important role. While the private sector is the engine of economic growth, governments can play an important role in creating an environment where growth can thrive or, conversely, where growth can be held back. Taxes and subsidies can have a great influence on the incentives to invest and innovate. Through public investments in education and infrastructure, governments can support the growth of the private sector. Regulatory actions by governments can improve the functioning of markets but can also increase administrative burdens on firms and raise costs. Business services, such as approval processes for construction projects, for the use of new capital equipment, or the release of land for development, can be crucial for economic development.

Ontario's combined corporate tax rate of 26.5 percent still compares favourably to many U.S. states, even after U.S. tax reform, but there has been an erosion of the previous tax advantage that Ontario enjoyed and a loss of tax competitiveness with some important trading partners such as Michigan and Ohio.

A recent assessment by Jack Mintz and his colleagues at the University of Calgary summarized the situation as follows:

*“The U.S. tax reform will provide a larger business tax advantage for U.S. states with corporate tax rates below the average U.S. rate and less so for states with relatively high corporate income tax rates. For example, Ontario’s federal-provincial corporate income tax rate is 26.5 per cent – this is lower than the combined federal-state corporate income tax rates in 39 U.S. states with a top corporate income tax rate above 6.33 per cent (e.g., California, Pennsylvania and New York), but higher than 11 other states with lower corporate tax rates (e.g., Michigan and Washington), five of which have no corporate income tax at all (e.g., Ohio and Texas). Thus, Ontario’s corporate income tax rate would be less competitive compared to, for example, Michigan and Ohio, but more competitive than New York.”<sup>8</sup>*

Ontario’s Manufacturing and Processing Tax Credit can reduce the provincial share of the combined tax rate for manufacturers from 11.5 percent to 10 percent. There is also a Small Business Deduction that reduces the tax rate on the first \$500,000 of active business income for small businesses to 3.5 percent from 11.5 percent. However, tax comparisons are complex and also need to take into account other tax provisions such as the new U.S. expensing provisions for new capital investments.

One summary measure used by organizations such as the OECD to compare business taxes in different jurisdictions is the marginal effective tax rate (METR) on new capital investment. The METR is a composite measure that takes into

account relevant tax rates, credits and deductions that affect the incentive to invest at the margin. According to the recent calculations by Mintz and his colleagues, Ontario’s METR in 2017 was 19 percent.<sup>9</sup> The recent U.S. tax reforms reduced the federal corporate tax rate from 35 percent to 21 percent, which resulted in a sharp reduction in the overall U.S. METR from 34.6 percent to 18.8 percent. This means that when we take a comprehensive view of tax competitiveness on investment, Ontario’s previous corporate tax advantage over the U.S. has now effectively disappeared. At the margin, this will adversely affect business investment decisions.

<sup>8</sup> Philip Bazel, Jack Mintz, and Austin Thompson, “2017 Tax Competitiveness Report: The Calm Before the Storm,” University of Calgary SPP Research Paper, Vol. 11:7, February 2018.

<sup>9</sup> Bazel, Mintz and Thompson, *ibid*, Table 1.

## Regulatory Burden on Business

Ontario is one of the most highly regulated business jurisdictions in North America. One figure that is frequently cited by critics is that Ontario has 380,000 regulations.<sup>10</sup> By comparison, the federal government, with admittedly different areas of jurisdiction, has about 130,000 regulations that impose an administrative burden on business.<sup>11</sup>

### Duplicating Regulations

A major Ontario auto parts manufacturer imports a piece of state-of-the-art equipment from Germany. The new equipment promises to improve the productivity of the manufacturer's Ontario plant and its ability to compete with plants in other jurisdictions.

Despite the fact that the equipment has met German workplace safety regulations and is currently in use in that country, the equipment sits idle for months, waiting for Ontario regulators to determine what regulations should apply and for inspectors to visit the plant.

A simple approach to streamlining regulations would be to recognize regulatory approval from trusted and comparable jurisdictions as meeting Ontario regulations, and in so doing avoid duplicating regulatory approvals that have already been granted elsewhere.

While regulations are an inevitable accompaniment to new legislation, continual efforts need to be taken to ensure that they are designed to minimize the administrative burden on businesses and individuals, and that they are applied effectively. There is a tendency to simply add new regulations to the existing inventory of old regulations, even when many older regulations are no

longer necessary or effective. Despite an effort by the previous Ontario government (Bill 154) late in its mandate in 2017 to reduce administrative costs by \$1.25 for every new \$1 imposed by new regulations, insufficient progress has been made in reducing the regulatory burden on business in Ontario.

<sup>10</sup> Philip Cross, "Ontario's staggering 380,000 regulations are warping the way business runs," Financial Post, May 3, 2016. <https://business.financialpost.com/opinion/philip-cross-ontarios-staggering-380000-regulations-are-warping-the-way-business-runs>.

<sup>11</sup> Canadian Chamber of Commerce, Death by 130,000 Cuts: Improving Canada's Regulatory Competitiveness, 2018.

## A Productivity Lens for Regulations

Ontario plants in global manufacturing firms may compete for production mandates not only with plants from other firms, but even with plants within their own firms. Productivity differences between Ontario plants and plants in other jurisdictions may be as small as a few percentage points, and plant managers are continuously looking for improvements that will give their plants a productivity edge relative to their intra-firm competitors.

Sometimes governments use business regulations to achieve their social policy goals. An unintended yet real consequence may be to make Ontario plants less competitive relative to plants in other jurisdictions.

Consider when governments increase the number of statutory holidays. An additional holiday may reduce the productivity of a plant by as much as one-half percent – which can be the difference between winning or losing a production mandate, and Ontario workers gaining or losing jobs. Governments should consider the productivity impact of new regulations before using them to achieve social policy goals.

Each year, the World Bank compares business regulations for domestic firms in 190 economies. The World Bank's Doing Business report for 2018 ranked Canada (in effect, Toronto, since the report was based on Toronto information<sup>12</sup>) very poorly for the time and cost to get construction permits, and the time and cost of getting connected to the electrical grid, among other matters. Canada also compares unfavourably with other countries for its high documentary compliance costs for borders, customs, and inspection procedures, which constrain cross-border trade with the U.S.

The World Economic Forum ranks countries' competitiveness each year using a Global Competitive Index. Canada has slipped in recent years in the rankings from ninth (in 2009-10) to 14th (in 2017-18). While Canada has many strengths relative to other countries, one remarkable aspect of the rankings is the fact that Canada ranks only 38th in addressing the burden of government regulations.

<sup>12</sup> World Bank, Doing Business 2018. <http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2018-Full-Report.pdf>

## Electricity Costs and Infrastructure

An important responsibility of government is to ensure the needs of citizens and businesses for safe, reliable, and efficient infrastructure are met. Financing and providing these services at reasonable cost adds to the challenges of government.

While Ontario's infrastructure is well-developed, strains are apparent that are inhibiting the province's growth. Most obviously, Ontario's electricity costs are high and a competitive disadvantage for business. A province that is so reliant on trade with the U.S. needs to ensure that its transportation networks – particularly highways, rails, bridges, and ports – are also fit for purpose.

Ontario's electricity costs are high for most industrial users. Large industrial users, however, currently receive relief.<sup>13</sup> Other industrial users face higher bills, though, than in Quebec, other provinces or some competing U.S. jurisdictions. This is a major relative burden for Ontario firms, and in order to address it, both short- and long-term

steps will be required on the part of provincial policymakers.

Highway congestion, especially on routes to the U.S. such as Highway 401, is now a serious constraint on trade. While railways are a both a federal and provincial responsibility, investments need to be made to expedite freight and commuter train traffic in major urban areas, notably the Greater Toronto-Hamilton Area (GTHA), and to better link other urban centres, such as Kitchener-Waterloo, to the GTHA. The provincial government has earmarked considerable resources for public infrastructure. These dollars should be targeted to public infrastructure projects, such as highway and transit, that will improve economic efficiency and enhance Ontario's competitiveness.

## Skills Training

Ontario has excellent universities and colleges but universities, in particular, need to be better oriented to the evolving needs of the job market.

There is an excess demand for engineers, technologists, and other skilled workers that is not currently being met by Ontario's educational institutions. Reliance on immigration is a stop-gap measure. Co-operative programs and apprenticeship programs are good examples of initiatives that have linked educational institutions with businesses, and provided better job opportunities for

graduates. Yet, Ontario's apprenticeship programs are underutilized in comparison with other jurisdictions, notably European jurisdictions such as Germany, that rely heavily on highly skilled workers. Rethinking the province's strategic mandate agreements with the universities to place a greater focus on high-demand backgrounds and skills can be part of a pro-competitiveness agenda.

<sup>13</sup> Grieg Mordue (2017), "Electricity Prices and Industrial Competitiveness: A Case Study of Final Assembly Automobile Manufacturing in the United States and Canada," *Energy Policy* 111: 32-40. Mordue points out that high electricity costs have not been a material impediment to competitiveness for large auto assemblers in Ontario.

## Business Services and Approval Processes

Ontario's business services are spread across many programs and agencies. Businesses find it difficult to navigate the bureaucracy in Ontario (and, indeed, Ottawa) to find the services they need. Yet many valuable programs have been set up to support small- and medium-sized enterprises – for example, to help locate opportunities in other markets, to support innovation, and so on. There is a need for better “one stop shopping” for business services in Ontario.

A constant concern by businesses in recent years has been the slowness and inefficiency of approval processes in the province. Whether for new construction projects, safety and health approvals of

new equipment, release of land for development, or many other matters, approval processes in the province have been criticized as slow and inefficient.

## Support for Investment and Innovation

There has been and continues to be strong policy and financial support at both the provincial and federal levels for innovation. This is laudable but it is also important, for the sake of sustainability, to attract private investment (both domestic and foreign).

In recent years, however, business investment in Ontario has been sluggish in large measure due to the underlying factors mentioned above, such as relatively high personal income taxes, labour costs, and the province's overall regulatory burden. It does not matter how generous public subsidies are. They cannot fully offset these deeper competitiveness challenges.

Encouragement of foreign direct investment, as well as domestic investment, is necessary. As is the case for business services, one-stop shopping is important for attracting investment. The new agency that the province has established, Investment Ontario, is a step in the right direction.

## III. An Agenda for Change

If the objective is to improve Ontario's long-term competitiveness and prosperity, a coherent and robust agenda that addresses the underlying problems needs to be pursued. Such an agenda will need to be holistic. There are no silver bullets. A pro-competitiveness agenda with thus have a number of elements addressing business and personal taxation, regulatory burden, skills training, and support for trade expansion, and investment attraction.

In this section, we focus our attention on two elements: first, reducing the regulatory burden on business while recognizing the legitimate public policy goals that

regulations seek to achieve and, second, addressing the non-regulatory burden of government on business.

### Stopping the Proliferation of New Regulations

The old adage tells us that when one finds oneself in a hole, the first step is to stop digging. The same adage applies to regulation and the administrative burden of government. Governments in a number of jurisdictions, most recently the U.S., have started to combat the proliferation of regulations by instituting rules like the 2-for-1 (TFO) rule, which states that two regulations must be eliminated for each new one that is introduced. After a new equilibrium is achieved, the rule can become reduced to 1-for-1.

A TFO rule can be a helpful tool to combat the proliferation of new regulations, but governments must apply it intelligently and be mindful of unintended consequences. The key is that the focus should be on measuring the economic and financial burden imposed by regulations, not just reducing their numbers. For example,

some regulations are actually enabling, that is, giving firms permission to engage in certain non-harmful activities despite a blanket ban in legislation. Eliminating enabling regulations might actually increase the burden on business, and thus make achieving the overall goal of regulatory reform more difficult.

The federal government's measure of the regulatory burden is thus not limited to the mere number of regulations. It involves an estimate of the economic and financial costs that different regulations impose on firms, in particular, and the economy in general. The result is the 1-for-1 rule is about substituting new regulations for existing ones based on the equivalent cost burden as opposed to merely adding one regulation and getting rid of another irrespective of their scope, size, and cost.<sup>14</sup>

<sup>14</sup> Sean Speer, Regulatory Budgeting: Lessons from Canada, R Street Institute, March 2016. <https://www.rstreet.org/wp-content/uploads/2016/03/RSTREET54.pdf>.

Another way to limit the proliferation of new regulations is to establish a regulatory challenge function within government. Typically, the enactment of new regulations is overseen by a cabinet committee like the Treasury Board. A dedicated unit in the Treasury Board establishes the requirements that must be met before new regulations will be passed, and advises ministers on whether new regulations pass muster – including whether the TFO rule has been appropriately applied. More importantly, this dedicated regulatory team provides ministers with advice on the overall value of a regulation in light of the

regulatory burden that will be imposed.

A third tool that can be used to constrain the growth of regulations is smarter use of stakeholder consultations and outside evidence. The federal government's Chemicals Management Plan is an example (see Box 3) of how bringing together stakeholders with different views and expertise, and making use of evidence from other jurisdictions, can help ensure that economics as well as other perspectives are considered when regulations are formulated.

### **Best Practice: The Chemicals Management Plan**

Canada regulates potentially hazardous chemicals under the Canadian Environmental Protection Act. The Chemicals Management Plan (CMP) was designed by Environment Canada to provide a risk-based approach to assessing new and existing chemicals using testing by best-practice regulators around the globe. A stakeholder advisory council brings together businesses, environmental groups, and scientists to provide advice to the regulator and to discuss issues related to the operation of the CMP. The best-practice approach to smart regulation of the CMP comes from its use of risk-based decision making, high-quality test results from outside Canada and its involvement of stakeholders from business, environmental, and scientific communities.

## Evaluating and Streamlining Existing Regulations

With literally hundreds of thousands of regulations on the books, it stands to reason that some are obsolete, others are ineffective, and others do not give due regard to the burden they impose on business. Taking on the task of streamlining this massive number of regulations is truly daunting. However, not all regulations are created equal. Some are particularly burdensome while others impose a relatively light burden on business.

How should we go about tackling the most burdensome regulations? An 80-20 rule approach (based on the notion that a small number of regulations cause businesses the greatest problems) may be warranted. Roundtable discussions with firms in the same industries could be convened to identify the top three most burdensome regulations along with improved ways of achieving the regulations' public policy goals. The recommendations from

these roundtables could be used to focus government action on short-term regulatory reform, and the roundtables could be further used to provide a forum for public servants to report on their progress. This triage approach to streamlining can help government focus its attention where it will do the most good, and force groups of firms to forge a consensus on what government action is most needed.

## Addressing the Non-Regulatory Burden of Government on Business

Governments can inadvertently impose non-regulatory burdens on business by failing to make timely decisions that businesses need, by failing to establish or meet service standards for business services that are important to businesses, or by not ensuring the accessibility of their programs. In many firms, for example, manufacturing firms, production processes have been periodically re-engineered to eliminate unnecessary delays or inefficiencies. Lean techniques have, in fact, revolutionized the production of automobiles and many other products. In government, services to business should similarly be subjected to continuous improvement through process re-engineering to eliminate undue delays and inefficiencies.

Delays in approval processes – for example, for a construction project, for the release of land for development, or for the use of new equipment – can severely constrain a firm's expansion plans and

put it at a competitive disadvantage. For a large plant in a small community, this can have a real impact on the community's economic development and its ability to attract new investment. Similarly, it

is important for government agencies interacting with businesses to have and respect clear service standards. Uncertain timelines or variable service can hamper business plans and delay new hires.

Businesses, especially small- to medium-sized businesses, often do not take advantage of the business services available to them at the provincial or federal level due to the complexity of navigating the respective bureaucracies (and the limited time and resources available to them). Many governments, including the Ontario and federal governments, have tried to develop concierge services, or one-stop shopping, to improve the accessibility of their programs. More, though, needs to be done to consolidate business services, improve outreach to small- and medium-sized businesses, and streamline application and approval processes.

## IV. Conclusion

Even if competitiveness is not a goal in itself, prosperity should be. And competitiveness is a necessary ingredient for investment, innovation, productivity, and, ultimately, higher living standards for Ontarians. The seriousness of the competitiveness challenge facing Ontario needs to be recognized. The views of those closest to the problem, the business community, cannot be discounted. Every year, corporate decisions are taken to invest in new plants or plant expansions either in Ontario or elsewhere, most often in the U.S. When these decisions go against investing more in Ontario, potential jobs and income are lost.

If the will is there, there is much that can be done to address the underlying issues affecting Ontario's competitiveness. While all elements that we have identified in this paper will need to be addressed – including business and personal taxation, the regulatory burden, electricity costs, skills training, business services, approval processes, and investment attraction – we have focused our attention on two

important areas where we think the new Ontario government can make a real difference for Ontario businesses: Reducing the regulatory burden on business and improving business-facing processes. Progress in these two areas will signal, in a concrete way, that Ontario is indeed open for business.

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