AN UPDATE TO TD ECONOMICS' 2002 REPORT ON THE GREATER TORONTO AREA (GTA) ECONOMY

Executive Summary

Five years ago, TD Economics released a comprehensive report on the opportunities and challenges facing Canada's largest urban region: *The Greater Toronto Area Economy: Canada's Primary Economic Locomotive in Need of Repairs.* In light of the flurry of developments that have transpired in the region since 2002, an update to the study was warranted. This report represents a look back at the last half decade, with a particular emphasis on answering three questions: what went right, what went wrong and what still needs to be done?

Many economic surprises in 2002-06

The 2002 report contained a 5-year economic forecast with some lofty expectations for the GTA. With the U.S. economy poised to rebound strongly from its recession at the outset of the decade and Canadian interest rates plumbing the depths, there appeared to be little stopping the GTA economy from recording brisk real economic growth of 3-3.5% per year and job creation of 2% during the next five years (2002-06). Even more importantly, the region appeared set to reverse – at least temporarily – the downtrend in real income per capita relative to other large North American city regions that had been witnessed during the 1990s.

The actual economic path taken since 2002 has been rife with surprises. The U.S. economic revival would unfold as expected, but a number of other developments would soon emerge that had eluded forecasters' radar detection. In addition to disruptions such as SARS and the power blackout of 2003, the region has struggled to adjust to a massive appreciation of nearly 50% in the value of the Canadian dollar against the greenback, a tripling in the average price of commodities and a rapid acceleration in Chinese competition. Nowhere was the impact felt more than in the manufacturing sector, where about 100,000 jobs – or about one in five – has been shed in the GTA since mid-2002. This is in stark contrast to the half decade leading up to the 2002 study, when manufacturing *added* 100,000 jobs.

This about-face in manufacturers' fortunes has weighed on the region's growth, but fortunately, not derailed it. One key counterbalancing force has come from the housing market, where the boom extended into its second decade, spreading offsetting benefits throughout the economy. A sizeable share of the 150,000 combined employment advance in the 2002-06 period in financial services, retail and wholesale trade and professional services was almost certainly owing to housing-related demand for credit, home renovations and legal and other services.

Another unanticipated setback came in 2003, when the newly-elected McGuinty government unveiled a $5.6 billion deficit. However, the Province has been able to eliminate the shortfall gradually without inflicting any collateral damage on the economy, assisted in part by rising transfer payments from the federal government.

Economic gains fall short

Putting it all together, real GDP growth ultimately came in at 2.5% per year in 2002-06 – short of our expectations, but a respectable showing under the circumstances. Meanwhile, the rate of average annual job creation actually came in bang on our forecast of 2%. And, in line with our projections, the region's population base continued to grow at a rapid pace of almost 2% per year in 2001-06, as the GTA continued to attract more than two in five of all Canada's newcomers.

The GTA's resilience in the face of the recent adversity has been encouraging. Still, the region continued to lose ground where it truly counts – in relative standard of living. With the moderate economic gains diminished by rising population in the GTA, real GDP per capita in the region increased at only 0.5% per year, about one-half the rate of the nation as a whole and one-third of the pace of other large city-regions in Canada. A comparison of real personal income per capita (another proxy of living standards) showed the GTA slipping further behind major U.S. cities – from US$7,500 in 2002 to US$8,500 in 2006.

Encouraging moves on the policy side

In the 2002 study, our view was that with the medium-term growth outlook relatively free of clouds, policymakers and leaders in the GTA could focus their attention on dismantling the longer-term roadblocks to growth and prosperity. We cited 6 areas in particular that required significant attention:

- Strengthen competitiveness
- Increase support for education
- Address growing urban sprawl
- Reduce poverty
- Reverse erosion of infrastructure
- Reduce shackles on municipalities

Although the surprising events since 2002 had the potential to significantly deflect attention toward taking measures to prop up short-term growth, government budgets have done a laudable job chipping away at these longer-term roadblocks. We discuss these initiatives on pages 10-23 of the Update. Notable mentions include substantial moves to reinvest in education and infrastructure, with the latter area further benefiting from last month's important $17 billion funding announcement for GTA-wide transit. Some other highlights include new measures aimed at helping low income individuals, stimulating investment in the auto sector, new Municipal Acts, and a new Growth Plan for the Greater Golden Horseshoe.

Stepped up efforts required

At the same time, however, accelerated efforts will be required by the region's players to counter some of the economic headwinds and ensure that the GTA economy flourishes in the next decade and beyond.

An illustration of the one-step-forward two-steps-back is in the area of competitiveness. All levels of government have taken positive steps in recent budgets. Chief among them include moves by the federal and provincial governments to eliminate capital taxes, which are highly destructive to growth, strengthen border infrastructure and support progress in expanding the research base. The City of Toronto has started the all-important move of lowering the property tax burden on industrial and commercial properties. Yet the GTA's once formidable cost advantage has been virtually wiped out by the 5-year run in the loonie. And with China and other developing markets expected to remain on a brisk growth path, there is unlikely to be any relief for the region from either a lower dollar or a sustained pull-back in commodity prices in the coming years. Nor is competition from these same developing market economies likely to abate. Some residents have taken comfort from the fact that the economy has still been able to churn out moderate growth over the past 5 years despite the ongoing fallout within the manufacturing sector. But as we have argued, a cyclical upswing in housing activity has helped to mask the impacts thus far – an effect that can't be counted on to continue indefinitely.

There are other new or existing challenges that will continue to complicate the road towards increased competitiveness. Since 2002, the need to reduce greenhouse gases and protect the environment has catapulted to the top of the region's priority list. With the environmental focus probably more than just the flavour of the day, there will continue to be growing demands on governments to better balance the goals of increased economic prosperity and sustainable development.

Meanwhile, significant resources in the GTA will continue to be absorbed by rising health costs or be drained away from the region in the form of income redistribution to other parts of Canada. Measures in the 2007 federal budget will reduce the net federal fiscal drag faced by the GTA – which had averaged a sizeable 4% of GDP between 1986 and 2002. Still, we raise the question of how much fiscal withdrawal is appropriate in today's age of increased global competitiveness.

We are encouraged that the GTA can meet the tall challenges before it, especially in light of the progress made since 2002. But, more than ever before, future policy actions will need to be underpinned by efficiency and innovation rather than new public money. For example, we call on the federal and provincial governments to enhance tax competitiveness by replacing the retail sales tax with a value-added tax. A greater tilt in the overall revenue mix toward user fees and sales/consumption taxes would allow more economically-detrimental taxes on income and capital to fall over time. And benefits can be found in the region turning to alternative or more innovative forms of service delivery, including public-private-partnerships (P3s)

Usually, times of challenge brings about strong leadership. We see a particular need for two players: the City of

Toronto and the private sector to step up and lead the charge. The City's flexibility has been limited by declining economic importance within the GTA and the existence of a large structural deficit. But while we urge the provincial government to upload a share of social service costs that were handed down to municipalities in the 1990s – the rationale being that these services are more appropriately funded off the income tax base – the City must do its job through efforts to better reallocate spending and emerge as a regional leader in terms of innovative program design and financing. Increased regional cooperation among municipalities could unleash benefits in the City and across the GTA. To that end, we are optimistic that the recent creation of the Greater Toronto Transit Authority (GTTA) by the province could mark a turning point, especially if endowed with similar revenue sources as those granted to the Greater Vancouver Transportation Authority. Tax increases should come lower down on the City of Toronto's priority list as a means of eliminating the budget shortfall. If applied, new taxes should be considered on the grounds of efficiency and achieving other social and environmental aims, rather than purely as a revenue grab.

Efforts to strengthen the GTA will run into a roadblock without increased participation from the private sector. The private sector needs to be more aggressive at taking advantage of new technologies and expanding research capacity to increase overall productivity. One of the benefits of a stronger loonie is that it lowers the cost of machinery and equipment imports. Yet total business spending on capital equipment in Ontario has increased at an anemic rate over the past half decade. China is providing tremendous possibilities for business expansion. But many companies in the GTA have yet to devise a China strategy.

In the 2002 GTA report, we highlighted the fact that business involvement in civic matters was crucial to the success of a city region. Happily, over the past five years, many private sector players have made tremendous inroads on this front. In particular, the Toronto City Summit Alliance (TCSA) – with over 2,000 volunteers across business, non-profit, government and labour – has been a considerable force in bringing the public and private sectors together to spur positive change.

All GTA players must form a united front

Above all, cohesive and coordinated action among all the region's players is crucial in order to make significant strides. And, here, we see considerable cause for optimism. Consider the area of poverty, which is among the most complex challenges confronted in the GTA. This issue is also among the most pressing. Newcomers to the region not only suffer from high and rising incidences of low income, but they are staying there longer. And over the next 20 years, international immigration will likely be the area's sole source of population growth.

A particular challenge in confronting poverty in the City of Toronto is its self-perpetuating nature. The communities deeply affected by poverty tend to record high drop out rates at school and weaker academic performances. Few of the people the poor are in regular contact with have links to opportunity.

While improving credential recognition and helping to boost language skills are part of the overall solution, the best way out of this predicament over the long run is for government, business and community groups to come together to improve educational outcomes within the affected areas and to assist in the transition to work. On this front, there have been some exciting new cooperative initiatives over the past five years that have been bearing fruit, including "Pathways for Education", the establishment of the Toronto Region Immigrant Employment Council (TRIEC) and the Youth Challenge Fund. Building on these kinds of efforts will be essential going forward.

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