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BIG CITY, BIG DIVIDE: HOW TO REDUCE ONTARIO'S GEOGRAPHIC INEQUALITY

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Issue

As outlined in a 2019 paper for Ontario 360, Ontario's investment, jobs, and economic activity have been highly concentrated in a small number of major cities for the past decade or so. This has led to various calls – including in the 2019 Fall Economic Statement – for the enactment of policies that can extend economic activity and employment opportunities to broader parts of the province, including its rural and economically-disadvantaged communities.

The question before Ontario's next government is: what mix of policies can catalyse greater economic activity outside of the province's major cities without creating significant market distortions?

Overview: Ontario's Geographic Inequality

Previous Ontario 360 work has analysed the concentration of the province's investment and employment in a small number of major cities. Consider, for instance, that of the 865,000 jobs created in the province between 2008 and August 2019 (when one of our previous papers was produced), 87.9 percent were concentrated in Toronto and Ottawa alone. The rest were distributed among the province's 14 other census metropolitan areas. Rural communities excluded from the CMAs experienced net job losses of 76,000 over this period.

It is hard to assess how the COVID-19 pandemic and its aftermath will affect these secular trends of urban-driven growth in general and the rise of "superstar cities" in particular. There are some who believe that the pandemic may lead to what has been described as "urban deagglomeration" which refers to a dispersal of people and economic activity from cities. Others argue that the COVID-19 experience will not lead to meaningful changes in where people live and work.

During the pandemic itself, the distribution of job losses was less concentrated in the province's major cities. Of the more than 980,000 jobs lost across the province due to the pandemic between March and June 2020, 59.8 percent were concentrated in Toronto and Ottawa. The two cities comprise roughly 52 percent of Ontario's population (see Table 1).

TABLE 1: Share of Provincial Population and Employment Losses, Toronto and Ottawa CMAs

	Population	Population %	Job losses (April-June 2020)	Job losses %
Ontario	12,453,300	-	981.2	-
Toronto	5,626,700	45.2%	504.1	51.4%
Ottawa	939,200	7.5%	82.7	8.4%

Source: Ontario Labour Market Report, March 2022

Last year's jobs recovery was more concentrated in these major cities. As of the end of 2021, Ottawa and Toronto were two of only five CMAs (along with London, Guelph and Peterborough) that had fully recovered pandemic employment losses. So far this year though the gains are more broadly distributed and now most CMAs have fully recovered jobs lost during the pandemic. Data for rural communities in the province are unavailable.

As for the longer-term recovery, it remains an open question whether high housing prices and the durability of the "work-from home" model will lead to less economic concentration in major cities. There have been plenty of commentaries written in the past 24 months speculating about how "superstar cities are in trouble."

The basic idea is that perhaps Ontario's geographic economic disparities may solve themselves through a process of migration based on this combination of high housing prices and new workplace arrangements. Such migration would ostensibly bring investment, jobs, and more economic activity to communities outside of Toronto and Ottawa.

It is not a far-fetched idea. Smart Prosperity Institute economist Mike Moffatt has documented that even prior to the pandemic we were seeing people leave the City of Toronto for other parts of the province. In 2020-21, for instance, Toronto lost 60,000 residents. The largest group were young families mostly leaving due to high housing prices – or as Moffatt puts it, "[they are] driving until they qualify for a home."

Although it is hard to know at this stage how durable these trends may be, there are some signs that predictions of significant deagglomeration will be proven wrong. A major one is immigration. Toronto has received 80 percent of immigrants to the province over the past 20 years and with the federal government increasing the annual settlement target to an annual average of roughly 445,000 over the next three years, the city's absolute settlement numbers are bound to go up.

This is the main reason that the Ontario government's own demographic projections anticipate that Toronto's population will grow by 47 percent by 2046. This estimate is 11-percentage points higher than the province's overall projected growth. Under this scenario, the Greater Toronto Area would account for nearly-two thirds of provincial population growth over this timeframe. The net effect is that more than half of Ontario's population will live in the region by 2046.

The upshot: all things being equal, it is likely that the pre-pandemic trend of a significant concentration of investment, jobs, and economic activity in a small number of Ontario's major cities will continue.

The Need for Reform: Shaping the Market but Minimizing Distortions

The economic forces leading to urban agglomeration are quite powerful. Economist Enrico Moretti's well-known book, *The Geography of Jobs*, outlines these various forces including the role of network effects and their consequences for entrepreneurship and innovation.

The key point here is that the concentration of investment, jobs, and economic activity in a small number of major cities is not a case of markets malfunctioning. It is a case of markets doing what markets do: they are allocating scarce resources according to their most efficient use. The rise of the intangible economy has also reinforced these trends of urban agglomeration and superstar cities.

This point is important because if Ontarians do not like these outcomes, they are unlikely to change on their own. It will therefore require a role for public policy to shape market forces in the direction of a broader geographic distribution of investment, jobs, and economic activity.

This will not be costless. Government intervention in the market will necessarily create some distortions and may produce efficiency losses. It does not mean that the government should not intervene. There may be good reasons to intervene in the name of equity, political stability, or other normative considerations. But it would be false to think there are no trade-offs.

It is crucial therefore to recognize government policy will need to be assessed based on something of a cost-benefit analysis. The key is to catalyse greater economic activity outside of major cities without creating significant market distortions. The economic costs should not outweigh the economic and social benefits broadly defined.

The Ontario government currently has various place-based policies to try to boost investment and employment in rural or economically-disadvantaged parts of the province. A good example is the Northern Ontario Heritage Fund which spends approximately $120 million per year on economic development projects in Northern Ontario communities. Its funding tends to come in the form of grants to businesses, research organizations, municipal governments, and non-profit organizations.

A more recent example is the Regional Opportunities Investment Tax Credit which was announced in the province's Economic and Fiscal Update in March 2020 and temporarily enhanced in 2021 Budget in March 2021. It functions as a 10-percent refundable tax credit for corporations that invest more than $50,000 to build, renovate or acquire commercial or industrial buildings in designated regions[1] across the province that lagged average employment growth between 2009 and 2019.

A key difference between these two examples is that the former is application based, the program's budget is capped, and funding decisions are ultimately made by the government. The latter is tax based, the budget is technically uncapped, and eligibility is automatic based on standard criteria.

There is a conceptual and empirical argument that a tax-based policy which reduces the potential for politicized decision-making and where public funds follow private investment decisions is less distortionary than an application-based grant program which is highly discretionary on the part of the government. Both approaches are "picking winners and losers" but the tax credit model is more neutral because every firm that is eligible according to the criteria is able to take advantage.

This point is worth emphasizing: any place-based policy interventions must start with recognition that they likely involve some degree of market distortions and a policy goal should be to design those interventions such that distortions are minimized. They probably cannot be eliminated but different policy choices can have more or less distortionary effects.

If the next Ontario government aims to advance a policy agenda to extend economic activity and employment opportunities beyond a small number of major cities, it will need to think carefully about different policy approaches and instruments.

[1] There are 34 regions across the province designated as eligible.

How to Move Forward

Here are three possible policy options for the next government's consideration.

1) Support municipalities to develop local economic development strategies

As outlined in a 2021 Ontario 360 paper, the City of Windsor has followed international best practices to carry out an independent evaluation of its economic strengths and weaknesses in the name of producing a medium-term economic strategy. This bottom-up exercise, which drew on what has been described as a "regeneration toolkit"[2], followed an evidence-based process to assess the city's sectoral strengths, community-based advantages, and policy gaps. It then identified a series of policy priorities (including the design and use of different policy incentives) to attract and boost investment and employment in the city.

The process was consultative, transparent, and evidence-based. It was broadly supported by Windsor City Council and stakeholders in the community. It is now forming the basis of municipal policymaking, including in collaboration with the provincial government.

As discussed in a recent Ontario 360 policy video, this type of placed-based economic development strategy is less prone to political economy issues than traditional industrial policies enacted by federal or provincial governments. There are also more likely to reflect local conditions and to secure local buy-in.

The basic idea is to have local policymakers and stakeholders carry out an evidence-based process to identify a community's economic and social advantages and to build an economic development strategy that accentuates them. It seems like a model that would be useful for other Ontario municipalities to adopt in order to inform their own policymaking.

The Ontario government could provide financial support to communities that opt to carry out similar processes as the City of Windsor. This would be a means for the provincial government to support economic development efforts outside of major cities without imposing its own assumptions and biases on these communities. Supporting bottom-up, placed-based efforts could bring greater coherence to local economic development policies and enable better collaboration with the provincial government.

[2] The same Ontario 360 paper applied the same regeneration toolkit to other Ontario communities including Oshawa, Peterborough, Sudbury and Thunder Bay though it did not produce a comprehensive set of policy priorities for these communities.

2) Decentralize government's footprint

As discussed in a 2019 Ontario 360 paper, there is potential to decentralize the Ontario government's physical footprint from the City of Toronto to other parts of the province. The government's recent announcement of its intention to transition the Ontario Workplace Safety and Insurance Board's headquarters from downtown Toronto to the City of London is a good example.

Such decentralization efforts should in theory be a win-win for the province. They can generate fiscal savings for the government in the form of asset sales or lower rental costs and bring employment and other auxiliary benefits to other parts of Ontario.

In practice, however, there are risks that this kind of initiative can be costly and operationally disruptive if it is not carried out with a high degree of evidence and intentionality, including a clear understanding of human resources capacity and a regional or sectoral connection to the type of government service being considered for transfer.

The U.K. government's decentralization exercise in 2004, which aimed to move 20,000 public sector positions out of Greater London and into economically-distressed regions, can be a possible model for Ontario policymakers. The government moved more than 25,000 jobs over a process of years. Research found that the relocated jobs had positive effects for local employment and economic activity.

3) Pursue the Opportunity Zones model

In a 2019 Ontario 360 paper, the case was made that the Ontario government should work with the federal government to adopt the Opportunity Zone model in the United States to incentivize private investment in economically-disadvantaged communities.

The basic model involves a series of tax inducements – particularly with respect to capital gains – to encourage individual and institutional investors to deploy capital to designated areas based on their economic conditions. The previous Ontario 360 paper provides a detailed explanation of how Opportunity Zones work. Although it remains too early to judge the model's effectiveness, there are some signs that it is producing positive outcomes.

The next Ontario government should champion the idea of experimenting with Opportunity Zones with other provincial governments and ultimately with the federal government. There is a need for such cooperation due to the federal-provincial integration of the tax system.

Although the Opportunity Zones model has its critics, a lot of the criticism seems to be about place-based policies in general. If the next provincial government believes that provincial policy should preference addressing geographic inequality, then the principal issue is about how to design such policy interventions.

The Opportunity Zones model, by and large, leaves investment decisions to a combination of market forces and investor choices. The only real condition is that investors must invest their capital in a designated zone. The model is otherwise generally market driven and neutral with respect to asset classes, investment structures and rates of return.

Conclusion

There are other policy options not reflected here, such as leveraging regional universities and colleges for innovation and talent, targeting international students and the Provincial Nominee Program, and boosting broadband investments.

The fundamental points remain, and are as follows:

- The pre-pandemic story of Ontario's economy was the concentration of investment and employment growth in a small number of major cities.
- Although it may have marginal effects, it is likely that the pandemic will not fundamentally change this trend.
- These trends are not a case of market failure per se. They are a function of markets allocating resources on the most efficient basis.
- There may be reasons, however, why the provincial government would try to influence the market's distribution of investment and employment in Ontario to benefit rural and economically-disadvantaged parts of the province.
- If so, it is important that any policy interventions aim to minimize market distortions and efficiency losses.
- The three policy recommendations set out above aim to achieve this balance by catalysing economic activity outside of Ontario's major cities while minimizing market distortions.

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