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The Decline of Ontario: A Neo-Innisian Approach[1]

Abstract
Ontario, Canada's economic and political heartland, has faced a manufacturing decline and significant public debt for the two last decades. The Alberta driven oil boom has pushed the Canadian center further to the West and challenged the traditional structure of the Canadian federation. The article focuses on the causes of this shrinkage and questions whether this decline has been accentuated by the increased dependency of the Canadian economy on staples, or by other internal or external structural deficiencies. The author concludes by evaluating the implications of the collapse of the Laurentian centre on fiscal federalism.

Résumé
Ontario, le coeur économique et politique du Canada, fait face au décline du secteur industriel ainsi qu'à la dette publique depuis deux décennies. Le boom pétrolier à Alberta a attiré le centre canadien plus à l'Ouest et a remis en cause la structure traditionnelle de la Fédération canadienne. Cet article fait sommairement le point sur les causes de ce changement en se demandant si ce déclin a été accentué par la dépéndence croissante de l'économie canadienne par rapport aux ressources naturelles ou bien s'il est l'expression de carences structurelles, internes ou externes. L'auteur conclut par une évaluation des implicassions potentielles de l'éffondrement de ce centre sur la Fédération.

Ontario has traditionally been the most dominant province in Canada, not only economically and demographically but also politically and culturally. Until very recently, the history of the province was closely linked with the history of the whole country and it was recognized as having a prominent position: on the one hand, Ottawa generally advanced the province's interests; on the other hand, Toronto attempted to play an integrating role in the federation. A number of recent newspaper articles covering the deteriorating performance of Ontario's economy, as well as an eloquent essay by John Ibbitson, "Collapse of the Laurentian Consensus," unveil changing patterns in the historical dominance of Ontario and raise questions about the economic and political factors that caused Ontario to change its relative position within Canada. This paper will test the hypothesis that the position of Ontario, the traditional industrial center of Canada, has been declining within Canada for the past two decades

1) This paper modifies and further elaborates on my chapter in the book *Spojené státy v úpadku? Vybrané problémy veřejné politiky v severoamerickém kontextu* that will be published in Czech in May 2013.

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due to the accentuated emphasis of the western Canadian economy on staples as well as its continental dependence. The main research technique employed is a comprehensive critical literature review, conceptually departing from Innis's staples theory. This analysis will also use a traditional 'centre–periphery' model, focusing on the spatial economic relations between Ontario and Alberta.

The Innisian approach

While reading the selected essays by Harold Innis, the pre-eminent political economist, in *Staples, Market and Cultural Change*, edited by Daniel Draché in 1995, the relevance of many of Innis's observations and comments, made back in the 1930s and 1940s, on staples and their impact on the structure and functioning of the Canadian economy is particularly surprising. "The economic history of Canada has been dominated by the discrepancy between the center and the margin of Western civilization. Energy has been directed toward the exploitation of staple products and the tendency has been cumulative" (Innis 16). The transportation system, industry, finance and government policies leaned towards the exploitation of unprocessed staples which were exported to specialised markets especially in the United States and Great Britain. This dependency was dictated by the lack of modern technologies and capital, which did not allow the processing of these staples within Canada. The domestic economy was thus vulnerable to volatility of both the demand for the commodity on the international market and the commodity price. Mel Watkins, in the 1960s, described the pitfall or vicious circle which the economy was caught in as a "staple trap" (Watkins 16). Besides this external dependence on foreign metropoles, Innis underlined the later role of the industrialized Laurentian center, especially Ontario, which partly processed the staples and exported them to foreign markets. The advantages of the St. Lawrence region were, according to Innis, increased by a government policy of protection (Innis 238).

By the 1950s, the staples approach to economics was giving way to the neoclassical economy. Then in the 1960s and 1970s, Innis was reappropriated by left-leaning nationalist intellectuals who explained Canada's relatively weak industrial base as a persistent staples dependence. During the 1990s, a new 'post staples' position emerged in partial opposition to this view. A new school of political economy, represented for example by Thomas Hutton, came up with a thesis in which staples dominance seemed to have broken down and the traditional resource dependency was transformed into a mature staple economy. Through this process of transformation, Thomas Hutton underlined, the Canadian economy opened up to the phase of a post-staple economy, more diversified and based on the service sector. Despite the rounds of reappropriation and criticism, recent policy trends provide reasons to update the staples approach and apply it to new questions. The author argues that the staples theory remains relevant for the current development of Canada since the beginning of the new millennium.

The industrial decline of Ontario

The picture of the Canadian economy in the 1980s and 1990s indicated that Canada might succeed in escaping from the staple trap and that it was pursuing the path toward Hutton's post-staple economy. Its economy was based more on the manufacturing sector, especially strong in Ontario. The natural resources and resource-related sectors remained a significant part of Canadian GDP; nevertheless, this dependency was weakened by booming manufacturing and growing services. Since the mid-1990s, for the first time in Canadian history, the value of non-processed or semi-processed natural resources accounted for less than half of all Canada's export goods (Drache 16).

Ontario has more than half of Canadian manufacturing jobs and this sector accounts for a major part of Ontario's GDP. The situation in Ontario stood out for being somewhat delayed, with manufacturing jobs beginning to decline only in 2004, while other OECD countries had already registered significant job losses in this sector since the late 1990s. Between 2002 and 2008 Ontario had to face delayed, though more severe impacts of the declining manufacturing sector, with 18% job losses and diminishing manufacturing output as a percentage of GDP from 23 to 15% (Industry Canada). Declining manufacturing output contributed to slower economic growth. In the same period, the province's GDP grew at an anemic 1.5% compared to a solid 3% expansion of the resource-based provinces of Alberta and Saskatchewan (Statistics Canada). This record deteriorated the relative economic power of Ontarians within Canada with possible important impacts on the current shape of the Canadian fiscal federation as discussed in more detail later in this paper.

The above facts raise the logical questions of whether this Ontario manufacturing decline is associated with the historical dimension of the Canadian economy which is replicating itself in the recent resource boom in Alberta or whether we have to search for internal causes in the domestic economy of Ontario or other external explanations. And perhaps most importantly, what are the future prospects for Canada if it continues to hollow out its industrial center and strengthen its strong resource dependence?

Ontario vs. the resource boom

The most frequently addressed challenge in this context is the connection between Alberta oil extraction, accelerated by rapidly growing WTI prices of oil since 2000, and the Canadian–U.S. exchange rate. The increase in world commodity prices that began in 2002 has generated a resource boom in Canada. Although metal prices also contributed to the boom, the rise in the price of oil has been particularly important. The increase in commodity prices was accompanied by a considerable appreciation of the Canada–U.S. exchange rate, in 2008 up nearly 50% from 2002. The export of oil and natural gas as a percentage of all Canadian exports has boomed since 2002. In 2002 energy exports, mainly composed of oil and natural gas, accounted for 9% of all Canadian exports, while in 2008 oil and gas exports enjoyed double-digit gains of 21% (Industry Canada, Trade Data Online). The more Canada exported resource-based goods, the more the Canadian dollar was referred to as a commodity-based currency.

While Canada has the world's third-largest proven reserves (after Saudi Arabia), it has little influence on the global price of crude oil and it is a 'price-taker' rather than 'price-maker', since domestic production is roughly 4% of total world production. As the CERI Study confirms, the strengthening of the Canadian dollar is from 78% correlated with the increase of world oil prices (Millington). Logically, due to the appreciation of the Canadian dollar, Canadian goods and services have become relatively more expensive to purchase with U.S. dollars, and thus Canadian exports to the U.S. have declined correspondingly.

The appreciation of the Canadian dollar makes Canadian exports more expensive and it impairs many Ontario businesses. The relationship between the natural resource export boom, currency appreciation and the decline of manufacturing is usually called the 'Dutch disease'. It is evident that the Dutch disease is not easy to prove statistically or visibly and the debate surrounding this causality is very ambiguous. The critics of this theoretical case underline that the decline of Ontario manufacturing is driven by different factors, especially by the rise of the emerging Asian economies; the economist Rayn Macdonald uses the term 'China syndrome' in this context. Over the past decade, the growing importance of the Asian emerging economies has significantly altered the global economic landscape. Given the fact that the United States is the dominant market for Ontario's exports (74% of Ontario's exports are sold in the U.S.), this surge of Chinese manufacturers has significantly jeopardized the competitiveness of Ontario businesses in the U.S. market. For instance, China's share of U.S. merchandise imports increased from 8% in 2000 to 18% in 2011, while Ontario's share of U.S. merchandise imports went down from 11% to 7% over the same period (Ontario Ministry of Finance).

Demographically, the resource boom has also had a major impact on Ontario. While booming western provinces pulled people from the Atlantic region and Ontario westward in the last 5 years, Ontario showed net losses in interprovincial migration. In turn, Alberta and Saskatchewan stood out in 2011 with a large number of net inter-provincial inflows (Statistics Canada, *Quarterly*). The 2011 census revealed that Ontario showed a very low rate of population growth (5.7%) while Alberta grew faster than the national average at 10.8% (Statistics Canada, *The Canadian*). The Ontario slowdown was caused mainly by two factors: as mentioned, more people were leaving for other provinces and fewer immigrants were coming to the province. In 2002 Ontario received 60% of all immigrants coming to Canada, while in 2011 the province received only 42% of newcomers (Statistics Canada, *Quarterly*). The majority of these immigrants were family members, while the independent economic immigrants headed more for Alberta. These factors accelerated the faster population aging in Ontario, compared with provinces further west. Ontario's working-age population as a share of the population is expected to decline by almost 9% by 2036 (Statistics Canada, *Quarterly*), which will worsen Ontario's comparative advantage in relation to Alberta in the long term. The 2011 census illustrates the relative decline of Ontario and the increasing demographic weight of the western provinces.

Nevertheless, bad news for one sector is not necessarily bad news for Ontario as a whole. The resource boom has also had a positive impact on Ontario's economic growth. In their report, Timilsina, LeBlanc and Walden calculate that out of the expected $884 billion cumulative GDP impact of Alberta oil development on the Canadian economy, Ontario will get 11% over the next 25 years (Timilsina et al. xii). This represents goods and services from companies in Ontario that export to Alberta and other resource-based provinces. The development of Ontario exports as a percentage of real GDP between 1990 and 2008 reveals two different trends: originally, after the period of strong continentalization Ontario increased its international exports to the U.S. and froze its interprovincial linkages, later the manufacturing crises reversed this trend and since 2005 the exports of goods and services from Ontario to other provinces increased by 11.7% (Ontario Ministry of Finance). The internal breakdown of the interprovincial trade statistics also demonstrates that while the traditional partner of Ontario, Quebec, purchased less goods and services from Ontario's firms, Alberta increased its share of exports from Ontario by 2% over this period.[2] In other words, the Alberta oil boom, fueled by the 2008–9 crises, in some sense reoriented Ontario's businesses back to interprovincial trade patterns and shifted it towards the West. This reorientation of trade patterns confirms the trend that John Ibbitson describes as the "collapse of Laurentian consensus". It is evident that the growing western demand related to resource development helped compensate Ontario's losses from currency appreciation; however, this structural transformation has not been sufficient for Ontario's full manufacturing recovery.

Ontario's dependent industrialization

Despite some negative constraints on Alberta's resource-based economic growth, such as the Dutch disease or demographical shifts in population patterns, the oil boom still cannot fully explain the structural problems that Ontario has had to face to since 2002. Many of Ontario's internal structural economic deficits are more a reflection of who the province traded with than how effectively it traded. Ontario's position in the middle of the St. Lawrence waterway predestined the province to serve as an outlet from the heart of the continent for staple products (Innis). In the early period, Ontario served as a transit shed for staple products, after the Confederation, it became the centre of industrialization. Throughout its entire history it was clearly the most export-dependent region of Canada.

The National Policy of high tariffs and barriers was conceived to help create an infant industry in Central Canada in the late 19th century; it was meant to subsidize domestically manufactured products which were destined for Atlantic Canada and western farmers, in exchange for staples. "[A] manufacturing sector," Mel Watkins underlines, "has emerged with difficulty around the staples sectors of the Canadian economy in some part through conscious state policy of an interventionist kind" (149). The National Policy was perceived, according to the classical centre–periphery theory, as a symbol of dominance of the centre over the periphery, imposing the central system of values and institutions onto the periphery. The National Policy brought about many social tensions between the clashing priorities of Central Canada, the Western and the Atlantic provinces, and its effectiveness remains highly controversial. Clearly in order to avoid the protectionist obstacles erected by the National Policy, American businesses set up the branch plant system, especially in Ontario, which served the Canadian domestic market and provided the technologies and financial capital that were lacking and were needed to further industrialize the economy of Ontario.

2) The author's calculations from various sources on interprovincial trade flows.

Subsequently, the industrial and financial interconnection between Ontario and the United States was enhanced by a sectorial free trade agreement in the automotive industry, the Autopact of 1965, and this continental integration culminated in the signature of the Canada–U.S. Free Trade Agreement of 1989. Logically, the province's manufacturing sector became increasingly reliant on automotive parts and assembly and is entirely foreign owned. The proximity to the Michigan–Ohio automotive cluster is both a key advantage and a disadvantage of Ontario's automotive manufacturing. The former brings the excellent comparative advantage of easy access to a large market and accessible infrastructure facilities, the latter leads to a risky dependency mentality which might impair creativity and innovation. Ontario is the only producer of automobiles in the world which does not produce its own automobile brand. Ontario's development of a major industrial sector, automobile production, is a classic example of what Innis called 'dependent industrialization' and what Watkins pejoratively described as a "miniature replica of American industry" (Watkins 113). According to Innis, this highly integrated industrial system of Ontario and the United States varies directly with the business cycle and the importance of the American market (Innis 197).

To keep pace with knowledge-based economies and remain competitive with emerging Asian economies, Ontario needs a dynamic, innovative and productive economy. The indicators of productivity growth and productivity level are generally seen as the basis for improvements in the real welfare of the economy, since they reflect the ability of the economy to produce higher outputs with lesser inputs. While sky-rocketing public debts have put a brake on government investment activities, high productivity growth represents an important tool for economic growth and prosperity of the economy. Ontario's performance on the productivity front compared with similar regions in North America reveals that Ontario has slid from the middle of the comparative scale 25 years ago, to the bottom of the ladder, along with Quebec and Michigan (Scoffield). While between 1985–2000, the growth of labor productivity averaged 1.3%, in 2001–2010 it reached only 0.5% (Industry Canada). This was mainly caused by the downturn of the automobile sector, representing the driving force of Ontario's labor productivity because the stronger service sector in principle manifests a lower productivity level.

A lack of public discussion on productivity enhancement measures suggests that Ontarians do not seem to have recognized this as a deficiency and therefore neither firms nor employers are motivated to change this deep-rooted approach. The two most efficient ways to enhance productivity are investment into research and development and efficient functioning of the labor market. Martin and Florida's report stresses that the mentality based on physical skills and repetitive work, the heritage of the American branch plant system, are more valued by Ontario employers than analytical and social skills (Martin and Florida). The employees' motivation to develop physical skills rather than analytical ones leaves the innovation potential of the Ontarian producers rather weak. According to comparative OECD data, Ontario firms' gap in capitalization of R&D is widening, especially in comparison to their U.S. counterparts. In the current information age, Canada's greatest comparative advantage must not be its rich endowment of natural resources but its citizens and their ideas. "There is nothing we could dig from the ground, draw from the oceans, harvest from our field and forest," Evan H. Potter suggests, "that will in the coming generation equal the value of what we will create with our minds. The leading nations of this century will be those that harness their citizens' knowledge and ideas to provide innovative solutions to the world's challenges" (5).

Roger Martin's frustration with the Ontario mentality's lack of recognition of the imminent shrinkage of Ontario's economic power reveals a very interesting psychological and identity comparison point, especially with regards to U.S. declinism. Historically, American politicians and pundits have regularly revived the idea of America's decline in economic and geopolitical power. Periodical crises followed by waves of the conviction that the United States is about to decline, as Samuel Huntington explained it, have become central to prevent a real shrinkage of power (Huntington 94–95). This 'paradox of prevision' made of the American hegemonic power a phoenix rising from the ashes repetitively. Historically rooted in the colonial mentality, Canada has never faced a similar challenge of exceptionalism. The current perception about the decline of the Laurentian center is neither widely debated nor very productive. Since the mid-1990s Canadian politicians have instead turned their focus to the West and its natural resources, with all their market instability and quasi-colonial dependence. The combination of the dependent mentality, slow productivity growth and under-average funding for research and development leaves Ontario weak and uncompetitive vis-a-vis foreign market turbulences and cheaper emerging competitors.

The implications for the federation

The aforementioned hollowing out of manufacturing and the economic recession have translated into serious fiscal implications for Ontario public budgets, as well as for the Canadian federation as a whole. It is useful to underline that natural resources are owned by the provinces. That means that the rents generated by exploiting natural resources can be appropriated by the provincial public sector. The unprecedented magnitude of the oil and gas boom in Alberta led to a massive concentration of wealth in this western province and gives it a much larger fiscal capacity relative to that of Ontario (or other non-oil provinces). There are two major existential challenges that a rising West and a declining Ontario might pose for the Canadian federation: firstly, to find a new formula to help redistribute the uneven wealth that is accumulated overwhelmingly in the West; secondly, to find an alternative to the failed National Policy for industrial economy focusing on a non-staples economy.

For decades, Ontario was one of the 'have-provinces' contributing to the federal equalization system which guarantees to all Canadians, wherever they live, a right to access comparable levels of public services at comparable levels of taxation. While Alberta's (and Saskatchewan's) ability to raise revenues has significantly increased thanks to the oil and gas extraction boom, Ontario's major source of revenues, manufacturing, has been amputated. Therefore, since 2010 Ontario has been one of the six have-not provinces. According to Jeffrey Simpson from *The Globe and Mail*, "this [fiscal] crippling represents the biggest change within the Confederation since the discovery of oil in Alberta" (Simpson). For more than half a century this federal–provincial fiscal arrangement remained more or less intact, underlying the constitutionally entrenched principle of equalization which stood out at the heart of the nationalist unifying vision of Canada, at least from the Laurentian perspective.

The effectiveness of this system, as many argue[3], has been subject to heated public debate, however Ontario with its strong industrial base was a financial, political and economic engine feeding this strong nationalist system. There are many voices stressing the economic unsustainability of the current system where only 'small provinces' contribute and 'large provinces' cash, when 70% of the Canadian population now lives in 'have-not' provinces. The current formula of equalization payments will expire in 2014 and the fierce debate between those opposing the ineffectiveness of the system and those defending its solidarity and unifying character unveils the implicit clash between traditional eastern nation-building strategies and more recent province-building strategies. This might have serious impact on the country's national unity. Not only will Canada's diverging economy yield strains between the Western 'have' and Eastern 'have-not' provinces, but some scholars anticipate a rise in tension within the Laurentian center, i.e. between Ontario and Quebec. Despite receiving equalization payments, Ontario still contributes more to the common fund than it receives and this raises hostilities against the largest 'non-have' province Quebec. However, joining the ranks of the equalization-receiving provinces, Thomas Courchene suggests, may turn out to be a liberating experience. Ontario may become much freer to pursue its own interests (54).

The provincial ownership of natural resources leading to uneven revenue-raising capacity may intensify greater asymmetric fiscal competition. On the one hand, the booming provinces (Alberta and Saskatchewan) have an incentive to use the rents for province-building and diversification rather than for nation-building strategies. On the other hand, the current shape of Ontario's economy and its public sector may suggest that Ontario will have no unique political power, nor superior fiscal capacity to push for an uneasy national consensus about the extent of the national sharing community. Boadway emphasizes "the potential that resource revenues give for provinces to engage single-mindedly in proactive province-building policies, possibly to the detriment of the development of the nation as a whole" (1). Consequently, the current shift to resource-based economic growth, risks weakening the federal government's capacity to mitigate the consequences of the oil and gas boom on other provinces, further advancing the decentralization of the Canadian federation.

Conclusion

Since the beginning of the new millennium, it is evident that Ontario has been losing its former position as the center of gravity and the engine of the Canadian economy. Several economic and demographic arguments in this paper demonstrated this relative decline of Ontario within Canada. Even if not all the effects are Alberta-oil-induced, this inter-dependence is, in Innis's words, very much a product of the historical dimension of the staples economy. The 'Ontario driven' nation-building strategy has expressed itself through the following trends: (1) federal government interventions to preserve the east–west balance within the federation initially through the National Policy and later through the current fiscal redistribution formula, (2) more pronounced north–south trade patterns leading to

3) See, for example, David MacKinnon.

Canada's excessive dependence on the U.S. Both trends that shaped and developed the post-staple characteristics of Ontario's economy in the past have been seriously challenged over the last two decades. The weakening of the Laurentian center leaves Canada as the weak link in the North American structure.

To conclude, Ontario remains the largest Canadian province and the financial and industrial hub of the country. Therefore its declining position within Canada may induce instability in the whole country, especially when conflicting province-building policies have been enhanced and at least until the moment when western Alberta, seconded by Saskatchewan, becomes the real center of the country and not only its resource-producing base dependent on the highly unstable and volatile external demand for non-renewable commodities.

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