RESEARCH
NOTE

#PARG 2022-15RN

The Likely Impacts of the Regional Opportunities Investments Tax Credit (ROITC)

Differing Impacts in Northern, Eastern, and Southwestern Ontario

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In its 2020 budget, the Ontario government introduced the Regional Opportunities Investment Tax Credit (ROITC). The ROITC is a corporate income tax credit for investments in commercial and industrial buildings in regions that experienced below average employment growth between 2009 and 2019. Essentially, the ROITC reduces the provincial tax liability for corporations that make qualifying investments in Northern, Eastern, and Southwestern Ontario. The ROITC was announced several months after the government pledged to explore "ways to encourage investment into rural and undercapitalized areas of the province" through means such as "potential changes to the tax system (Ontario 2019, 50). Place-based tax incentives are widely used by governments seeking to encourage economic activity in less prosperous regions; however, the effectiveness of these incentives is questionable.

This study analyzes the likely impacts of the ROITC. It explores, first, whether place-based investment tax incentives like the ROITC are generally effective at promoting economic development in targeted regions and, second, how the impacts of the ROITC are likely to vary between Northern, Eastern, and Southwestern Ontario. This note is part of a sequence of three research notes. The first note sets the context for the series by discussing how the ROITC works, the extent of regional economic disparities in Ontario, and theories of regional economic divergence. The second note uses literature and data regarding previous place-based investment tax incentives to determine the usual impacts of such policies. This final note will draw on the first two notes to explain how the impacts of the ROITC are likely to vary between Northern, Eastern, and Southwestern Ontario.

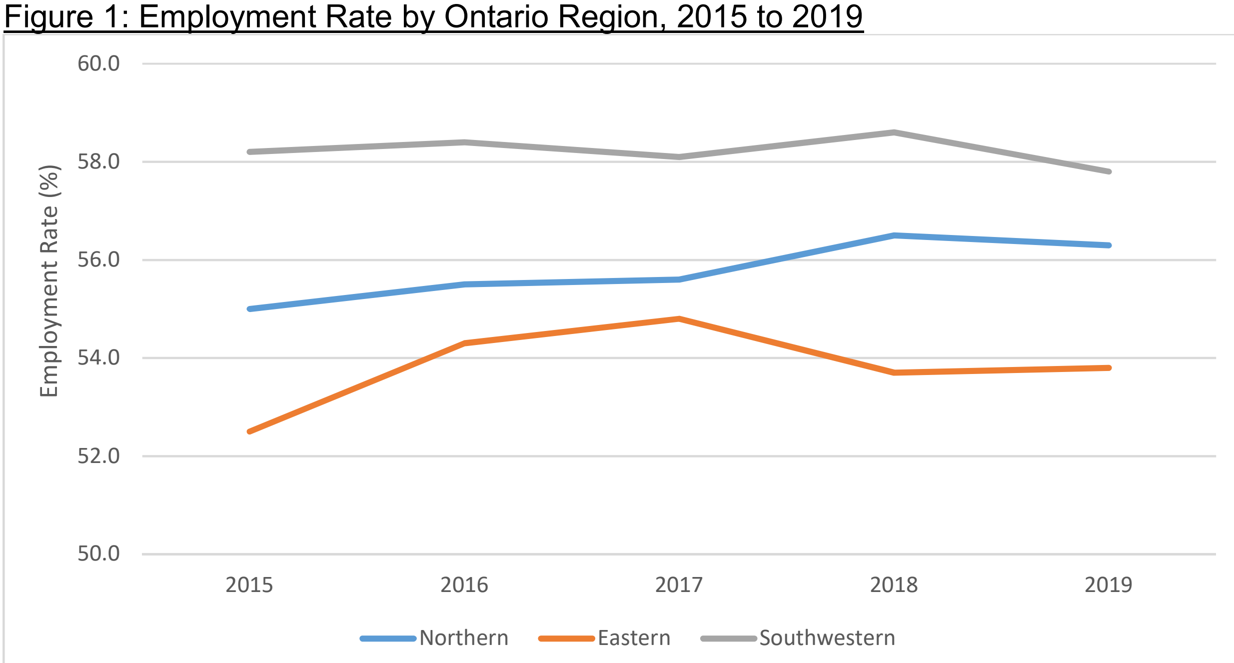
Regional Analysis

This note discusses the different impacts that the ROITC is likely to have in Northern, Eastern, and Southwestern Ontario. First, an assessment is done to determine each region's level of economic disadvantage, and the capital intensity of its business sector. As explained in the previous note (PARG #2022-14RN), less economically disadvantaged regions with more capital-intensive business sectors can be expected to benefit more from the ROITC. Second, the major economic challenges and opportunities facing each region are identified, and analysis is provided regarding the extent to which the ROITC can assist regional economies in navigating these realities.

Level of economic disadvantage

As Figure 1 and Table 1 illustrate, Northern, Eastern, and Southwestern Ontario experience varying levels of economic disadvantage. Southwestern Ontario is the least disadvantaged of the three regions and is therefore likely to receive a disproportionately large share of ROITC-subsidized investments. Of the three regions, Southwestern Ontario enjoys the highest employment rates and highest rates of employment growth. The region also enjoys the second highest median after-tax income – only narrowly lower than that of Eastern Ontario. Northern and Eastern Ontario are more economically disadvantaged than Southwestern Ontario, but neither is definitively more disadvantaged. Northern Ontario enjoys marginally better employment and employment growth rates, but median incomes are higher in Eastern Ontario.

Figure 1: Employment Rate by Ontario Region, 2015 to 2019



Data sources: Statistics Canada 2021a, Statistics Canada 2022

Table 1: Key Economic Indicators by Ontario Region

Region	Employment growth (2009-2019)	Employment rate range (2015-2019)	Median after-tax household income (2016)
Northern	-0.4% to 2.1%	55.0% to 56.5%	$57,848
Eastern	-5.9% to 2.1%	52.5% to 54.8%	$59,046
Southwestern	4.5% to 6.3%	57.8% to 58.6%	$58,870

Data sources: Statistics Canada 2017, Statistics Canada 2021a, Statistics Canada 2021b, Statistics Canada 2022

Capital intensity

Knowing the industrial composition of each region and having estimates of the capital intensity of various industries, it is possible to estimate the capital intensity of each region's business sector. Figures for each region's industrial composition are sourced from the 2016 census (Statistics Canada 2021b) and estimates of the capital intensity of various industries per hours worked are sourced from the Centre for the Study of Living Standards (2012).

Of the three ROITC-eligible regions, Southwestern Ontario has the most capital-intensive business sector. Northern Ontario's business sector is slightly less capital-intensive than Southwestern Ontario's, but much more capital-intensive than the business sector in Eastern Ontario. It can be expected that the capital-intensive business sectors of Southwestern Ontario, and to a slightly lesser extent, Northern Ontario will benefit disproportionately from a capital tax credit like the ROITC.

Southwestern Ontario's business sector is the most capital intensive because several capital-intensive industries are highly concentrated in the region, at least relative to Northern and Eastern Ontario. Southwestern Ontario's economy has long had a large manufacturing industry. Moreover, Southwestern Ontario has the largest finance, insurance, and real estate industry of the three regions. The relatively high capital intensity of Northern Ontario's business sector stems from the region's large and very capital-intensive natural resource extraction industries, particularly mining.

Challenges and opportunities: Northern Ontario

Northern Ontario is distinct from the rest of the province in two crucial respects. First, Northern Ontario is sparsely populated compared to the southern regions and most Northern Ontario communities are quite remote. This produces several economic challenges. Remoteness leads to higher costs of energy, transportation, and financing and results in many firms being isolated from larger cluster (FedNor 2017, 8). Transportation and communications infrastructure is lacking, further impeding business (FedNor 2017, 8). The ROITC can partially alleviate the high cost of doing business; however, as Pew Charitable Trust (2012, 10) notes, even substantial tax incentives are often insufficient to attract investment to areas that lack sufficient infrastructure.

Second, Northern Ontario's economy is relatively undiversified and reliant on natural resources. As explained in Porter's cluster theory, economic specialization can lead to prosperity via the development of strong, industry-specific local clusters. Small natural resource-oriented clusters exist in Northern Ontario, most significantly the mining cluster centred around Greater Sudbury (FedNor 2017, 5). The nature of natural resource extraction, however, limits the extent to which clusters can develop; mining must ultimately take place where minerals are located. Northern Ontario's resource dependency has left its economy vulnerable to volatile global commodity markets, boom and bust cycles, and changes in currency exchange rates (Conteh 2017, 8). Growing global demand for minerals found in Northern Ontario represents an economic opportunity for the region. The remote Ring of Fire, for instance, has resources valued at over $60 billion (FedNor 2017, 5). And as mining is quite capital-intensive, the ROITC can provide valuable financial assistance to new developments. Nevertheless, the fate of projects like the Ring of Fire depends on many factors beyond the cost of capital, most significantly provincial willingness to build the required infrastructure and provide environmental approval.

Northern Ontario's final economic challenge is less unique. The region's labour force is less educated and skilled than the provincial average and is set to deteriorate further due to an aging and declining population (FedNor 2017, 7). In the language of this paper's theoretical framework, one key centrifugal force is weak in Northern Ontario: people, and the associated labour and consumer markets. Even if businesses stand to benefit from the ROITC, they may not invest in Northern Ontario if they cannot recruit skilled workers. The ROITC can potentially be a valuable subsidy to Northern Ontario's many capital-intensive businesses. Nevertheless, this tax incentive has limited potential to compensate for the region's remoteness, undiversified economy, and relatively weak labour force.

Challenges and opportunities: Eastern Ontario

The ROITC has moderate potential to promote economic growth in Eastern Ontario. A tax credit that reduces the cost of capital should help address major causes of the region's economic struggles, and proximity to core regions creates economic opportunities that might not exist in Northern Ontario. Nevertheless, Eastern Ontario's economy will continue to be constrained by factors that the ROITC does not address.

Compared to Northern Ontario, Eastern Ontario is in a better location to attract business. The region is close to major economic and population centres in both Canada and the United States, and this proximity is enhanced through strong transportation linkages (EOLC 2019). This reduced isolation reduces transportation costs. Further, it reduces the strength of centripetal forces as Eastern Ontario retains some access to the large labour and consumer markets, as well as productivity-enhancing information spillovers, found in core regions.

A tax credit like the ROITC that reduces the cost of capital could be particularly beneficial in Eastern Ontario for two reasons. First, Eastern Ontario businesses cite access to capital and financing as a major barrier to growth (EOLC 2019, 20). Reducing the cost of capital should help alleviate this problem. Second, there is reason to believe that the ROITC could be particularly effective at stimulating investment in manufacturing. Eastern Ontario has historically had a modest manufacturing industry, but the region has seen a decline in manufacturing employment since the 2008 recession with 5,000 jobs lost between 2011 and 2016 alone (EOLC 2019, 38). There is evidence that many of these job losses were the result of an increase in input costs; specifically, the cost of one input: electricity.

Aliakbari and Mckitrick (2017) estimate that 64% of manufacturing jobs lost in Ontario between 2008 and 2015 can be attributed to steeply rising electricity prices over the same period. Fewer jobs were lost in other Canadian provinces or in American states that did not experience similar increases in electricity prices. Because the decline of manufacturing was largely the result of high input costs, a capital tax credit like the ROITC that reduces input costs could help restore Ontario's competitive position for manufacturing, particularly if subsidized investment increases energy efficiency of the capital stock. In doing so, the ROITC may create manufacturing jobs in Eastern Ontario.

Eastern Ontario shares many of Northern Ontario's demographic and infrastructure challenges. The region has an aging and shrinking population, skilled labour shortages, and gaps in communications infrastructure (EOLC 2019, 6). Fortunately, these problems are likely easier to address in Eastern Ontario. The region's proximity to major population centres, coupled with its high quality of life, could facilitate the attraction of newcomers (EOLC 2019, 20). As Eastern Ontario is less remote than Northern Ontario, infrastructure gaps should be easier to resolve.

Challenges and opportunities: Southwestern Ontario

Once again, the ROITC appears likely to be most beneficial in Southwestern Ontario. Historically, Southwestern Ontario's economy has relied heavily on manufacturing. The decline of manufacturing is widely recognized as the primary cause of Southwestern Ontario's recent economic downturn (Eisen and Emes 2016; WOWC 2017). As noted in the previous discussion regarding Eastern Ontario, since it appears that the decline of manufacturing across Ontario was largely the result of rising input costs, a capital tax credit like the ROITC addresses a root cause of this decline. The Western Ontario Wardens' Caucus (2017, 10) – which represents an area roughly equivalent to Southwestern Ontario – explains that while large manufacturing assembly plants are unlikely to return, many smaller more tech-driven manufacturing operations have emerged in the region recently. The ROITC should help many of these small manufacturing operations finance expansions, as well as attract new manufacturers to the region.

Southwestern Ontario shares some economic challenges with Northern and Eastern Ontario. The local business and economic development community have identified shortages of highly skilled and educated workers, along with gaps in transportation and communications infrastructure, as barriers to growth (WOWC 2017, 17). While these challenges are not addressed by the ROITC, they appear to be less significant in Southwestern Ontario than in the other two regions. Southwestern Ontario's population is not yet declining, labour shortages are modest, and the region's high quality of life could help attract newcomers (WOWC 2017, 17-26).

Given the region's large manufacturing base, sizeable tertiary industries relative to Northern and Eastern Ontario, and proximity to Ontario's principal core region, one can question whether Southwestern Ontario should truly be considered a peripheral region. It would be inappropriate to deem the region "core" given its significant agricultural industry, largely rural nature, and small tertiary industries relative to the Greater Golden Horseshoe and Ottawa. At the same time, the region is less peripheral than Northern and Eastern Ontario. Southwestern Ontario is perhaps best described as "semi-peripheral". As a semi-peripheral region, Southwestern Ontario enjoys some of the agglomeration economies experienced in core regions. Consequently, firms in secondary and tertiary industries in Southwestern Ontario experience a lesser competitive disadvantage than those in Northern or Eastern Ontario. As a result, investments can be viable in a wider range of economic activity, increasing opportunities for the cost advantage provided by the ROITC to attract business. This is another avenue through which the ROITC is likely to disproportionately benefit Southwestern Ontario.

Conclusion

Northern, Eastern, and Southwestern Ontario vary according to their level of economic disadvantage, industrial composition, and broader economic reality. These factors influence the level of investment and employment that the ROITC is likely to attract to each region. Owing to a relatively prosperous local economy, a highly capital-intensive business sector, a large manufacturing sector with potential to rebound in response to lower input costs, and to being a "semi-peripheral" region, Southwestern Ontario is likely to benefit most from the ROITC. Northern and Eastern Ontario will almost certainly receive some economic benefits through the ROITC, but these are unlikely to be as significant as in Southwestern Ontario.

Policy Recommendations

To quote the Ontario government's Fall 2019 economic outlook and fiscal review, "in order for Ontario to be a global leader in job growth and the premier destination to start a new business, all regions of the province should share in prosperity". The ROITC can be reformed to stimulate economic growth more effectively in *all* regions of the province. There is strong evidence that the ROITC will disproportionately benefit the relatively prosperous, capital-intensive, and semi-peripheral economy of Southwestern Ontario.

To attract greater investment to Northern and Eastern Ontario, the size of the tax credit should vary across regions, as is done under the Italian Law 388/2000 program for example. As in Italy, economically disadvantaged regions of Ontario are not equally disadvantaged. Despite this fact, the ROITC offers a uniform 20 percent credit on investments across all economic regions that experienced below average employment growth between 2009 and 2019. The ROITC should offer greater credits for investments made in more disadvantaged regions. As demonstrated by the North Carolina tax credits discussed in the previous note, when governments offer larger subsidies for investing in the most disadvantaged areas, a greater share of subsidized investments are made in said areas (Perez and Suher 2020).

For the ROITC, a model along the following lines could be adopted. Investments made in census divisions where employment growth has been below average, but above 5 percent, receive a 10 percent credit. Investments made in census divisions where employment growth has been between 0 and 5 percent receive a 20 percent credit. Finally, investments made in census divisions that have experienced negative employment growth receive a 30 percent credit.

Another reform worthy of consideration would be to replace the ROITC with a program similar to the Opportunity Zones model from the United States. A program that offers tax incentives on capital gains rather than corporate income might provide a more favourable cost-benefit mix. Ontario could even introduce regional differentiation into an OZ-type model by requiring funds to hold a certain percentage of their assets in especially disadvantaged areas.

Finally, the ideal regional development policy in Ontario could eschew targeted regional incentives like the ROITC. The Ontario government pursues many policies that contribute to regional economic divergence: an immigrant nominee system that privileges the economic needs of the Greater Golden Horseshoe, underinvestment in rural infrastructure, and environmental policies whose benefits are spread evenly across the province but whose costs are concentrated in peripheral regions. Adopting policies that better serve the needs of peripheral regions would represent a better regional development policy than the use of place-based incentives like the ROITC that are rarely cost-effective.

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