



MOWAT RESEARCH #166 | JULY 2018

A Fair Fiscal Deal

Towards a more principled allocation
of federal transfers

Mowat Centre

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ONTARIO'S VOICE ON PUBLIC POLICY

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The federal
government
should ensure
that allocations
are principled,
and treat
Canadians fairly
regardless of
which province
they reside in.

EXECUTIVE SUMMARY

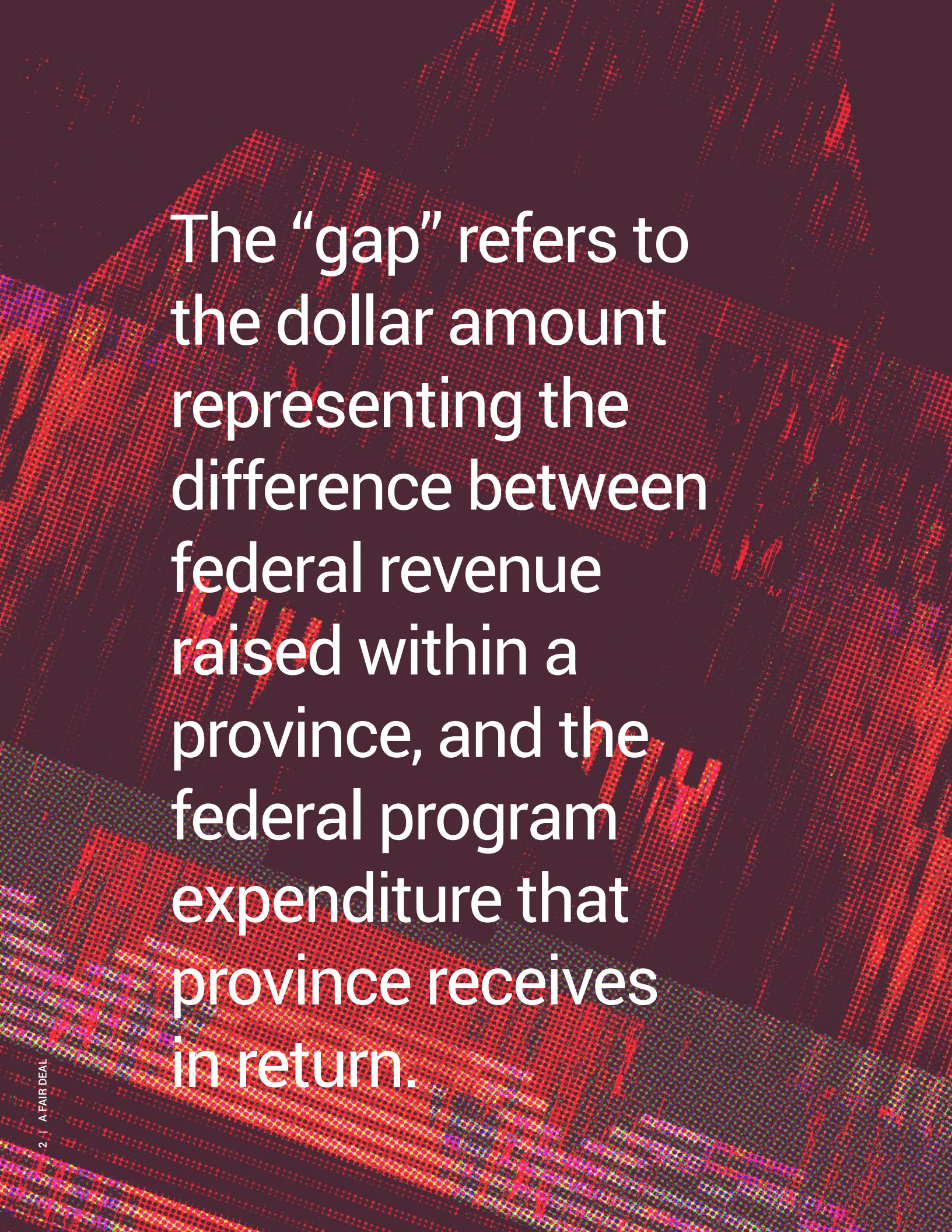
Earlier this summer, the federal government announced that it had renewed the terms of the Equalization program for another five years, leaving them largely unchanged. This move sparked the usual debate about the formula – about who should qualify for Equalization, and for how much. It also sparked a broader debate about fairness, and about how Canada’s wealth should be shared, both among provinces and among citizens.

In debates about federal transfers and fairness, Equalization is often used as a shorthand for inter-regional redistribution in general – it is the most visible means we have of smoothing out the distribution of the country’s wealth across geographic regions. But the narrow focus on Equalization can often muddy the waters. When it comes to how the federal government moves money from one part of Canada to another, there are many more pieces in play than just the Equalization program. The federal government allocates over \$300 billion in annual program spending through an array of programs and transfers, and does so according numerous different parameters and formulas.

The conversation about fairness, therefore, should be broad enough to cover all forms of redistribution. Despite the fact that Ontario has received Equalization since 2009, Ontarians are still net contributors to the federation: when the sum of all federal spending is aggregated, the province’s residents receive less from direct federal spending and transfers than they pay in federal taxes. New data shows that in 2016, this net contribution, or “gap,” was nearly \$13 billion, more than double what it was six years ago. A good deal of this gap is attributable to federal funding that is not allocated according to clear or consistent principles. As a result, Ontarians have a case for being treated unfairly.

This report takes a look back at Ontario’s contribution to the federation over the past ten years. It employs data about federal transfers paid to both provinces and individuals and attempts to assess if they are allocated fairly or not. Using these data in tandem with principles developed by the Mowat Centre in previous publications on this topic, the report highlights areas of underlying unfairness in how federal funds are distributed across the federation. It then offers a roadmap for how transfers like Equalization should be distributed, in accordance with more robust principles.

Importantly, the purpose of this report is neither to argue against the value and necessity of redistribution, nor to lament the fact that Ontario, as a comparatively wealthier province, will inevitably end up contributing more to the federation than it receives. The purpose, rather, is to make the case that the flows of funding should be traceable back to principles that stand up to scrutiny.



The “gap” refers to the dollar amount representing the difference between federal revenue raised within a province, and the federal program expenditure that province receives in return.

1 INTRODUCTION

Discussions of fiscal federalism usually revolve around federal transfers to provincial governments, such as Equalization, the Canada Social Transfer (CST), and the Canada Health Transfer (CHT). Indeed, these transfers constitute the bulk of the debate around how funds are allocated across decentralized governments, like the federal and provincial counterparts in Canada.

But there are other large transfers that often go undiscussed in the context of fiscal federalism, many of which are paid directly to individuals. Redistribution of these funds can be a contentious topic among politicians and scholars, and questions of fairness arise when residents in one province contribute more to federal spending than they see invested in their province.

There are many different ways these funds are distributed across the federation. Some are allocated on the basis of a simple, easy-to-follow principle. For example, both the CHT and CST are paid to the provinces on an equal-per-capita basis (i.e. the amount paid is equal to that province's share of the population).

Other funds are allocated in ways that are often perceived as unprincipled or outdated. For example, Employment Insurance (EI) and the Labour Market Development Agreements have not been updated to reflect today's shifting labour market.

This report argues that a fair allocation of funds is crucial for a healthy federation. As some funds are collected in parts of the country and spent in others, the federal government should see to it that allocations to individuals and provinces alike are principled, and treat Canadians fairly regardless of which province they reside in.

Interprovincial politics can also flare up when some provinces argue that they receive less support from the federal government than others. This can lead to mistrust between levels of government and to inter-regional tension, reducing Canadian governments' ability to take collaborative action when necessary.

This report attempts to assess how fair allocations are in certain aspects of federal spending. Major transfers to individuals as well as to provinces will be discussed, with a particular focus on Ontario. Access to ten years of new fiscal data¹ allows us to more fully measure Ontarians' contribution to the federation, and to assess whether and how these major transfers have been contributing to the fiscal gap in Ontario.

¹ The dataset that balance of confederation calculations were based on was suspended for a number of years. That suspension was lifted in 2016, but with only six years of data available at the time. The data set has now been extended to span ten years, from 2007 to 2016.

What do we mean by the fiscal gap? The “gap” refers to the dollar amount representing the difference between federal revenue raised within a province, and the federal program expenditure that province receives in return. When calculating this figure for Ontario, we are basically asking; what is the difference between what Ontarians contribute to Ottawa through their federal taxes and what they receive? And is that difference justifiable in terms of fairness?

This report comes at a critical juncture for Ontario. Over the past ten years, Ontario has been in the unique position of being the only province that is both a net contributor to the federation in general and a recipient of Equalization payments. While Ontario’s Equalization payments have declined in recent years, the federal government’s recent renewal of the program could see the province continue to receive payments, even if it has above average revenue-raising capacity.² Should this materialize, it is sure to attract plenty of criticism as unprincipled “over-equalizing,” and Ontario could unwittingly find itself at the centre of this controversy.

Taking a step back to assess Ontario’s overall contribution to the federation, not just its status vis-à-vis the Equalization program, provides useful context here. In six short years, Ontarians have seen their annual net contribution to the federation double, from \$6.5 billion in 2010 to \$12.9 billion in 2016. A considerable proportion of this gap is attributable to the continued unprincipled allocation of federal funding.

Ontarians have long supported the notion that prosperity should be shared across Canada, so a fiscal gap of some degree has generally been acceptable. But this does not mean that funds should be re-allocated from Ontario without a view to fairness as well. In that regard, this report assesses whether federal spending is allocated fairly based on simple principles, and how unprincipled allocations contribute to the gap. The report then recommends how to better achieve fair and principled allocations of federal spending across the country.

2 <https://mowatcentre.ca/risk-sharing-not-equalization-is-failing-alberta/>.

2 10-YEAR RECAP OF ONTARIO'S CONTRIBUTION

The Mowat Centre has published extensively on the subject of fiscal federalism and Ontario's place within it. In this body of work we developed a methodology for assessing Ontario's net contribution to the federation, and a framework for assessing its fairness.

Previously, available data has only allowed us to create snapshots of given years. The analysis in this report draws on new data to look at a period of 10 years, from 2007 to 2016. We analyze Ontario's net contribution over that time frame. We then assess the fairness of a few important federal spending programs that make up a significant part of federal spending.

As was reported by Mowat in 2013³ and 2017⁴, Ontario has been a net contributor to the federation in each of the years for which data was available. An analysis of newly-available data shows this has in fact been the case in each of the past ten years.

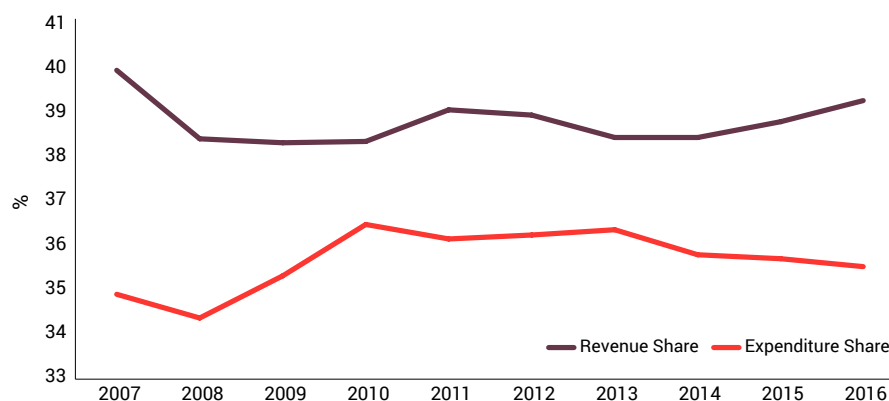
This means Ontarians have paid more towards federal revenue (e.g. through taxes on individuals and businesses), than they have received in federal program spending (e.g. through programs such as EI and "other transfers" to the province). As Figure 1 shows, using a balanced budget approach (see Appendix), the share of federal program expenditure in Ontario is consistently less than the share of adjusted federal revenue raised in Ontario. This was in spite of Ontario having received Equalization since 2009.

3 Zon, N (2013). "Filling the Gap". *Mowat Centre*. https://mowatcentre.ca/wp-content/uploads/publications/62_filling_the_gap.pdf.

4 Hartmann, E. and Thirgood, J, (2017) "Mind The Gap: Ontario's Persistent Net Contribution to the Federation". *Mowat Centre*. https://mowatcentre.ca/wp-content/uploads/publications/142_mind_the_gap.pdf.

FIGURE 1

Ontario's share of adjusted federal revenue and share of adjusted total federal program expenditure in Ontario

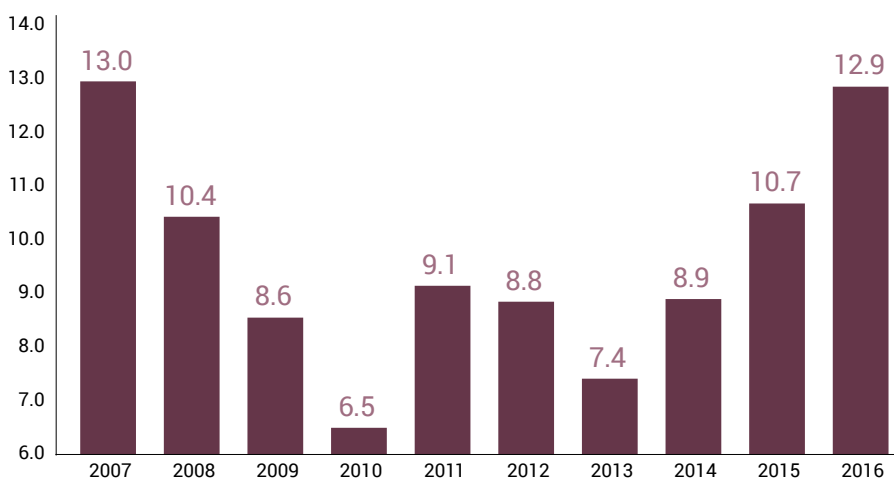


Source: Mowat Centre calculation

Ontarians net contribution has ranged from a low of \$6.5 billion in 2010 to \$12.9 billion in both 2007 and 2016 (see Figure 2). Over the span of ten years from 2007 to 2016, Ontario's cumulative fiscal gap was \$96.2 billion (see Figure 3).

FIGURE 2

Ontarians' net contribution to the federation, 2007 to 2016 (\$ billions)



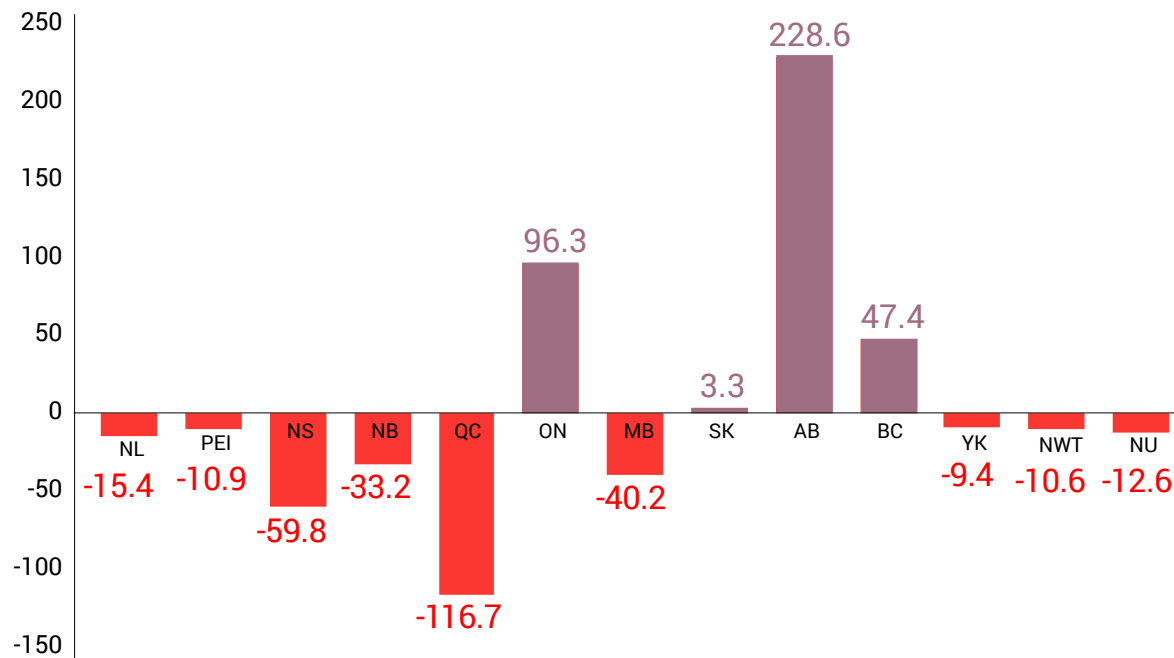
Source: Mowat Centre calculation

Ontario was not the only net contributor over that period. Alberta, British Columbia and Saskatchewan were also net contributors the federation. Alberta was the largest net contributor over that period, with a cumulative net contribution of \$228.6 billion. On the other end of the spectrum, Quebec was the highest net benefactor in absolute terms, having received a cumulative net benefit of \$116.7 billion over 10 years.⁵ Among the net beneficiaries, however, Quebec's net benefit is the lowest in per capita terms.

⁵ Quebec being a net benefactor and Alberta being a net contributor does not necessarily imply an unprincipled allocation of federal funding in and of itself. By way of example, Alberta's per capita fiscal capacity for the purposes of calculating Equalization was over 50 per cent higher than Quebec's in 2016.

FIGURE 3

Cumulative Net Contribution to/ (Benefit from) the Federation, 2007 to 2016 (\$ billions)



Source: Mowat Centre calculation

Although the above graph presents provinces' 10-year cumulative contribution, each year's respective contribution chart looks similar in terms of distribution. Alberta, Ontario and British Columbia were net contributors in each year, whereas Quebec, Manitoba, the Atlantic Provinces and the territories were consistent net beneficiaries. Saskatchewan changed from net beneficiary to net contributor status in 2009.

3 PRINCIPLED APPROACHES TO ALLOCATION

That Ontario has been a consistent net contributor since at least 2007 is not, in and of itself unfair. A certain amount of distribution is necessary in a federation, and Ontarians have by and large supported this.

It is important, however, that such redistribution be done in a principled manner. This report discusses a set of principled allocation methods that can be used to achieve various policy objectives. Assessing certain key federal programs through the lens of these principles demonstrates that Ontario is indeed not getting its fair share of federal funding in some important areas.

The Mowat Centre has consistently argued for a more principled approach to allocating federal spending. In *Slicing the Pie* (2012) we developed, based on a review of best practices from other federations, four guiding principles to determine the appropriate approach to allocating transfer payments across a federation.⁶ Allocation of federal transfers should be:

- » Clear and transparent
- » Fair to Canadians regardless of where they live
- » Consistent with policy objectives of the transfer
- » Predictable, with the flexibility to adapt to changing circumstances

Depending on the circumstances, allocations can take a number of forms and still be consistent with these principles. The same comparative review of other federations around the world found four distinct approaches to principled allocation (see Figure 4).

FIGURE 4
Approaches to principled allocation of federal transfers

Per capita	Allocates to each government a share of the transfer equal to their share of the population.
Per client	Distributes federal transfers based on a province or territory's share of the population that would be targeted for assistance by the program.
Need based	Accounts for the demand for, and different cost of, providing comparable services in different parts of the country.
Merit based	The federal government makes a pool of funding available for a program with clear criteria, and jurisdictions or organizations that meet those criteria are free to apply.

Source: Zon, N. "Slicing the Pie". *Mowat Centre*. https://mowatcentre.ca/wp-content/uploads/publications/90_slicing_the_pie.pdf.

⁶ Zon, Noah. (2012). "Slicing the Pie: Principles for Allocating Transfer Payments in the Canadian Federation." *Mowat Centre*.

Principled allocations allow provinces to get their fair share of federal funding – and assure citizens they are not being mistreated in the federation. This can go farther to ensuring that provinces can provide relatively equal programs and services across the federation, while increasing the public accountability of federal redistribution. And as we show below, principled allocations can not only reduce the fiscal gap in Ontario, but be a blueprint for more equitable distribution of funds across the federation by ensuring that all provinces and territories receive what they need.

Principled allocations can be a blueprint for more equitable distribution of funds across the federation by ensuring that all provinces and territories receive what they need.

4 ANALYSIS: ARE FEDERAL TRANSFERS PRINCIPLED?

How well do the allocations of federal transfers to both provinces and individuals meet the guidelines for principled allocations laid out above?

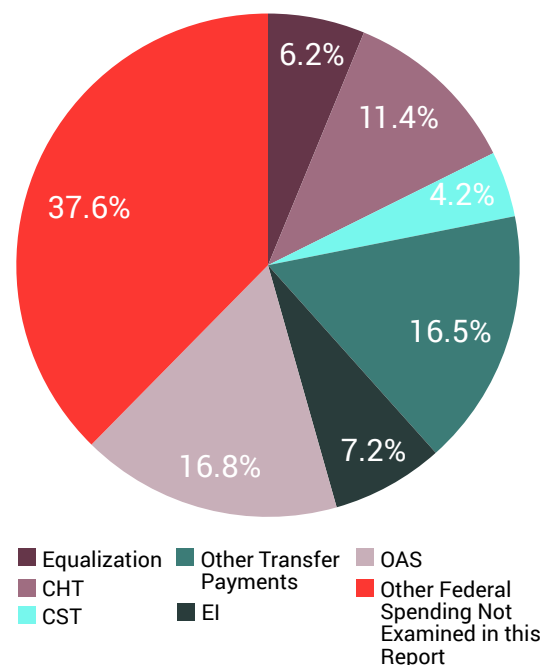
We examine five federal program areas – Equalization, the CHT and CST, “other transfers,” EI, and Old Age Security (OAS) – which together equate to almost two-thirds of all federal expenses in 2016-17 (see Figure 5). We assess the fairness of allocations in these program areas using the “principled allocations” framework outlined in the previous section, with the “per-capita,” “per-client,” and “needs-based” approaches as the litmus test. We then propose improvements where unprincipled allocations are found.

Transfers to provinces and territories

Transfers to provinces and territories include Equalization, the CHT and CST, and “other transfers.” These federal transfers are used to enable subnational governments to provide various public services and programs to residents. The three major transfers, along with Territorial Formula Financing, account for a large portion of federal program spending, 23.2 per cent in 2016-17. Other transfers, which also include transfers to provinces and territories, are also a major federal expenditure, representing 16.5 per cent of federal program spending.

Our assessment shows that within those broad categories, there exists both principled and unprincipled allocations of funding.

FIGURE 5
Spending areas examined by this report as a share of total federal program expenditure, 2016-17



Source: Public Accounts of Canada, 2016-17
Note: The Quebec Abatement was subtracted from the CHT and CST.

Equalization

PURPOSE

The purpose of the Equalization program, as laid out in Section 36(2) of the Constitution, is to enable provinces to provide reasonably comparable services at reasonably comparable tax rates. Currently, the program seeks to achieve this purpose by addressing disparities in revenue-raising capacity among provinces. The federal government transfers federal funds to provinces with below average “revenue-raising capacity.” Provinces with higher capacity to raise revenue do not receive Equalization.

PRINCIPLE

Springing from its Constitutional mandate, Equalization is, at its core, a needs-based system. This is a key component of redistribution in Canada.

But beyond differences in revenue-raising capacity, there are significant interprovincial differences in both the costs of delivering services and the workloads they face. And while the Equalization program currently measures and equalizes provincial revenue-raising capacity, it makes no attempt to equalize differences in this “expenditure need” across provinces.

ASSESSMENT

The failure to recognize differences in expenditure need between provinces is an unprincipled gap between the program’s objective and its allocation formula. Factoring these differences into the determination of Equalization payments would go a considerable way to ensuring the program is truly needs-based.

Vertical and Horizontal Fiscal Imbalances

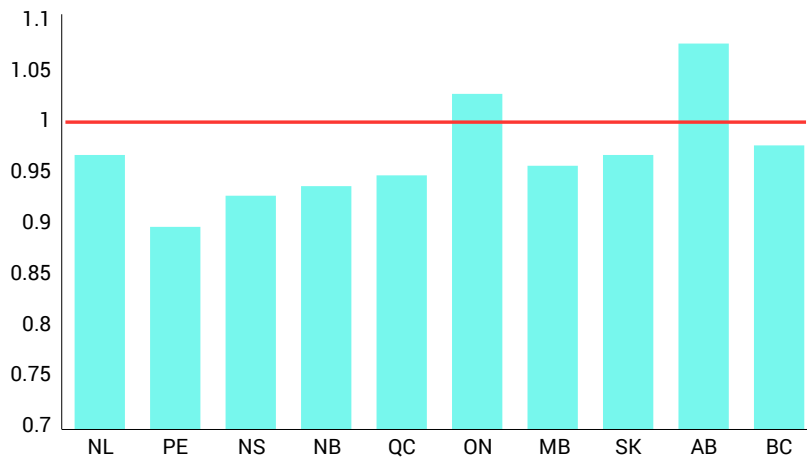
It has been argued that the CHT and CST should also be calculated according to a needs-based approach. However, the CHT and CST are transfers designed primarily to address the vertical fiscal imbalance between the federal and provincial-territorial governments. That is, the federal government occupies more revenue room than it needs to discharge its constitutional responsibilities and the provincial-territorial governments occupy less. Transfers such as the CHT and CST are used to address, in part, this imbalance.

Individual provinces also vary horizontally between themselves in both their capacity to raise revenues and their expenditure need. Equalization is the program the federal program that designed to address horizontal fiscal imbalances between provinces.

Including needs-based or equalizing elements in transfers meant to address vertical fiscal imbalances limits their ability to achieve their main policy goal. Equalization should be the primary tool for addressing horizontal fiscal imbalances between provinces.

FIGURE 6

Provincial/local government expenditure price index, all province average = 1, 2009



Source: Gusen, Peter. (2012). "Expenditure Need: Equalization's Other Half." Mowat Centre.

Measuring expenditure need is a tricky calculation, but at its core it seeks to account for differences in costs provinces face in the delivery of public services. Factors that account for these differences include variances in both workloads and prices.

Not all provinces face the same workloads. For example, some provinces have greater proportions of seniors which would create above average need to spend on health care. Other provinces may have more school-aged children than average, creating greater relative demand on their education systems. Geographic considerations such as rurality and remoteness can also lead to increased costs of service delivery. Input costs for government services such as wages and prices can also vary significantly. In jurisdictions where private sector wages are higher for example, it costs more to compensate doctors and teachers in a competitive fashion.

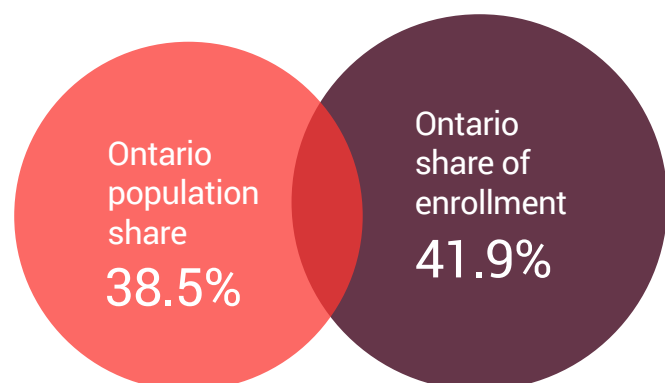
How does the omission of expenditure need affect Ontario? An analysis published by the Mowat Centre in 2012 found that Ontario, along with Alberta, faces the highest prices in Canada (see Figure 6). The main contributor to the provincial price index differences is wages. Employee remuneration directly absorbs over 40 per cent of provincial and local government budgets, and indirectly drives the prices of many of the other goods and services that governments purchase.⁷

Ontario also faces relatively high workloads in certain sectors. For example, Ontario's share of Canada's elementary and secondary school enrollment figures exceeds Ontario's share of Canada's population, indicating an above average workload in the education sector for the province (see Figure 7).

In the 2012 analysis, applying all of the workload and cost factors across all provincial spending sectors indicated that Ontario has an above average expenditure need (see Figure 8).

7 Gusen, Peter. (2012). "Expenditure Need: Equalization's Other Half." Mowat Centre.

FIGURE 7
Ontario's share of Canada's primary and secondary school enrollment and total population, 2015



Source: Statistics Canada. Tables 477-0025 and 051-0001.

FIGURE 8
Expenditure need Equalization entitlements, \$ million, 2008-09

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
Health	165	-19	167	165	-467	-178	-28	289	-848	752
Elementary and Secondary Education	-43	-9	-154	-96	-1,242	753	191	195	896	-491
Post Secondary Education	-45	-39	16	-133	-783	286	-89	-70	1141	-285
Social Assistance	63	-15	46	89	675	26	-160	-82	-821	179
Other Social Services	170	-5	219	57	-1,300	-66	44	0	157	724
Total Expenditure Need*	310	-86	294	83	-3,117	822	-42	332	526	879

Source: Gusen, Peter. (2012). "Expenditure Need: Equalization's Other Half." Mowat Centre.

Note: a positive number means above average expenditure need

Ontario's expenditure need in 2008-09 was the second highest in Canada, behind British Columbia. Overall, a recognition of differences in "expenditure need" would not require the federal government to spend more on Equalization. It would, however, substantially alter the provincial distribution of payments towards higher cost jurisdictions, including Ontario.⁸

⁸ Gusen, P. (2012). "Expenditure Need: Equalization's other half". *Mowat Centre*. https://mowatcentre.ca/wp-content/uploads/publications/46_expenditure_need.pdf.

RECOMMENDATIONS

The federal government's recent renewal of the Equalization program continues the practice of equalizing solely on the capacity to raise revenues. It also maintains provisions that may subject the program to increased criticism as unprincipled.

The federal government has recently decided to continue the unprincipled practice of detaching the amount it spends on Equalization from the formula used to calculate which provinces qualify for funding. This practice was initially introduced a decade ago as a way to put a ceiling on payments in order to save costs. Now that ceiling has become a floor, which can result in payments flowing to provinces with above average revenue-raising capacity. That very thing happened this year when Ontario received its Equalization payment, and may continue in the years to come. That is not the way Equalization is supposed to work. Should that happen again, however, the above analysis shows that the problem would not be that Ontario qualified for Equalization, but that it qualified for the wrong reasons.

Equalization currently only does half its job, but could be allocated on a fairer basis by incorporating expenditure need into the program's formula. Provinces face significant differences in services delivery costs that should be recognized by the program. The result would be a rebalancing of payments towards higher cost jurisdictions such as Ontario. Other provinces such as Saskatchewan, that are close to average revenue-raising capacity but also face relatively higher costs, could also benefit from such a change. A slow transition to such a system could be implemented quite simply to ensure no province is majorly disrupted by the change. Overall, a move to an Equalization program that accounts for differences in revenue-raising capacity and expenditure need represents a principled way forward and would better equip the program to perform its Constitutional mandate.

Canada Health and Social Transfers

PURPOSE

The Canada Health Transfer (CHT) and Canada Social Transfer (CST) are two of the largest and most well-known transfers in the fiscal federalism landscape. They support provincial governments in providing of health, post-secondary education and social services.

The CHT is the largest major transfer to provincial and territorial governments. It supports provinces' and territories' spending on health care on the condition that they uphold the principles of the Canada Health Act: universality; comprehensiveness; portability; accessibility; and, public administration.

The CST is a block transfer to support provinces' and territories' spending on post-secondary education, social assistance, social services, early childhood development and early learning and childcare.

PRINCIPLE

The CHT and CST are the primary vehicles to address the vertical fiscal imbalance between the federal and provincial-territorial governments. Since the purpose of these major transfers is to enable provincial governments to provide public services to each and every resident, the funding should feasibly be approached on a per-capita basis.

ASSESSMENT

Today, both the CHT and CST are provided on a per-capita basis, meaning that the funding received by provincial governments from the federal government is proportional to their share of the country's population. This was not the

case until quite recently: while the CST has been allocated on a per-capita basis since the 2007-08 fiscal year, the decision to allocate the CHT on a per-capita basis was not made until the 2014-15 fiscal year. The move to do so was paired with a transitional strategy to ensure that no province received less than its 2013-14 cash allocation in future years as a result of the change.

RECOMMENDATIONS

With both the CHT and CST transfers now being allocated on a per-capita basis, their allocation is relatively fair and principled. Neither have contributed to Ontario's fiscal gap in a significant way.

"Other Transfers"

One of the biggest factors that contribute to Ontario's fiscal gap comes in the form of "other transfers to provincial and territorial governments." This category includes multiple smaller, transfers targeted to specific programs. It also provides the federal government with an opportunity to provide funding for specific programs that might relate to its mandate but not fit neatly into its jurisdiction.

Each of the dozens of these "other transfers" has its own policy rationale and allocation formula. The Provincial Economic Accounts, the main source of data used to calculate federal spending in each province and territory, does not break down data for the "other transfers" category according to individual transfers. It is therefore not possible to analyze the fairness of each individual transfer based on those data.

Instead, this paper tests whether the "other transfers" category are allocated on a principled basis by calculating "other transfers" per capita as a proxy. In doing so, we used an "adjusted national average" – a national average that does

not include Newfoundland, Nova Scotia, and the territories because these jurisdiction have special arrangements with the federal government to reflect their unique needs and resources.⁹

In every year except one, Ontario received below average per-capita payments from “other transfers.” The exception was in 2010, when the federal government made a one-time payment to the province to ease the transition to Harmonized Sales Tax. Ontario also received the lowest per-capita payments of all provinces in six of the ten years. If Ontario had received funding from “other transfers” at the national average level over the last ten years, it would have cumulatively received an additional \$10.3 billion in payments.

The unpredictability of this category of payments, as well as Ontario receiving less per-capita payments than most other provinces over the ten-year period, warrants a closer analysis of

whether or not allocations are fair. Increasing Ontario’s per-capita payments to the national average would be an improvement, but still remain imperfect, as many different formulas for respective programs exist within this category, each with their own allocation principles. Per-capita allocations are used here simply to illustrate how much funding each Ontarian receives in this category of transfers. Therefore, a discussion of alternatives, like moving to a per-client allocation instead of a per-capita one, would not readily map to this scenario as each program is different.

Nonetheless, even with this unpredictable category, it is important that allocations be principled. This can be illustrated by the example of the Labour Market Development Agreements (LMDAs).

FIGURE 9

Per-capita funding from “other transfers” in Ontario compared with the adjusted national average (\$ per capita, unless otherwise noted)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Ontario	316	284	265	623	277	302	242	239	249	238
Adjusted national average	328	334	348	501	376	412	416	389	350	342
Difference	12	50	83	-121	93	110	174	150	101	105
Gap (\$ millions)	158	638	1,073	-1,593	1,303	1,470	2,349	2,051	1,390	1,461
Total (\$ millions)										10,300

Source: Provincial Economic Accounts and Mowat calculations

⁹ We use averages without Newfoundland and Nova Scotia due to their special fiscal arrangements with the federal government that take into consideration their offshore petroleum resources. We exclude the territories due to their disproportionately large transfers on a per capita basis from the Territorial Formula Financing.

Labour Market Development Agreements

PURPOSE

In Canada, labour market transfers such as LMDAs are the largest federal-provincial transfer to support the country's active labour market policies (ALMPs). ALMPs are used to assist unemployed and under-employed Canadians by providing them with training, skills development and job search services.

PRINCIPLE

LMDA funding is used to support a broad range of programs and services delivered by provincial governments - all of which have different goals and mandates. The most simple, transparent and principled approach to LMDA funding would thus be a per-client basis, whereby the client is unemployed Canadians. Proportional transfers to provinces for active labour market programming would be expected to mirror each province's portion of the national unemployed population.

ASSESSMENT

LMDA allocations are, generally, not distributed equally or rationally. The complex LMDA allocation formula was designed to equalize the provincial impacts of the 1996 EI reforms. The formula has hardly been revised since then, despite dramatic shifts in the labour market.

Today, this allocation disadvantages Ontario and the Prairie provinces: in 2015 for example, Ontario received 29.5 per cent of federal LMDA allocations despite having 37.8 per cent of the nation's unemployed population.¹⁰ There has been no obvious principled rationale for this:

10 Morden, M. (2016). "Back to Work: Modernizing Canada's labour market partnership". *Mowat Centre*. https://mowatcentre.ca/wp-content/uploads/publications/123_back_to_work.pdf.

Ontario struggles with long-term unemployment, having the second longest average tenure of unemployment after Quebec.

RECOMMENDATIONS

To make these allocations more fair and equitable, the federal government should – at a minimum – revisit the outdated formula used to determine allocations. Funds for ALMPs such as LMDAs should be allocated on the basis of a province's share of the unemployed population. The system should be more "client-focused" than "systems focused" – a criticism highlighted by the OECD in its assessment of Canada's complex network of programs and services for the unemployed.¹¹ In an attempt to rectify this, the federal government should consider a single federal-provincial transfer agreement based on negotiations with each province, to simplify a complex web of programs. This should also be funded out of general revenues in addition to EI premiums, as a means of eliminating the distinction between insured and uninsured unemployed workers.¹²

Looking forward, a similar level of scrutiny regarding fairness should be applied to all federal transfers. For example, the Parliamentary Budget Officer recently pointed out that the funding allocated through Phase I of the federal infrastructure program has been extremely uneven across provinces with significant variances on a per-capita basis. Nationally, the mean spending under the program was \$703

11 Organization for Economic Co-operation and Development. 2015a. "Back to Work: Canada: Improving the Re-employment Prospects of Displaced Workers". Paris: *OECD Publishing*. Retrieved online from: http://www.oecdilibrary.org/employment/back-to-workcanada_9789264233454-en.

12 For more on the history of Canada's public employment service and recommendations for improvement, see: Morden, M. (2016). "Back to Work: Modernizing Canada's labour market partnership." *Mowat Centre*.

per person, but in Ontario was only \$161.¹³ It may yet be too early to set off alarm bells. Significant portions of the Phase I infrastructure funding were supposed to have been allocated in ways that benefit Ontario. Funding for public transit for example, was to have been allocated according to transit ridership levels, a measure weighted in Ontario's favour. It is possible that federal infrastructure funding in Ontario has been disproportionately attached projects deferred to future years. Over the course of the federal infrastructure program, the test of fairness may indeed be met. At this stage, there is not enough data to make an accurate assessment.

However, the significant differences between the levels of funding that provinces received from a program meant to engender economic stimulus calls into question whether the federal government's approach to infrastructure funding is overly restrictive to achieve that result. Ottawa's insistence on overly-rigid conditions has both slowed the roll-out of its infrastructure programs and limited its ability to support provincial and local priorities.

Transfers to individuals

While transfers to the provinces and territories enable subnational governments to deliver public services and programs, transfers to individuals and households are those made directly by the federal government to residents within and across provinces. Various benefits that are administered by the federal government fall into this category, such as EI, OAS, children's benefits, the Goods and Services Tax Credit and Military Veterans' benefits.

The following section will examine the two largest expenditures in this category of transfers: EI and OAS, which accounted for 7.2 per cent and 16.8 per cent of federal program spending in 2016-17, respectively. While transfers for OAS are largely allocated in a principled manner, there are potential changes to EI that could improve fairness and transparency in its allocation.

Employment Insurance

PURPOSE

Employment Insurance (EI) remains a critical piece of Canada's social architecture. Generally speaking, the EI program aims to provide assistance for Canadians temporarily out of work. While the EI system is comprised of numerous programs, the bulk of program expenditure is directed towards "regular benefits" – temporary income assistance for individuals who have lost a job through no fault of their own.

PRINCIPLE

In theory, contributory schemes such as EI should benefit most – if not all – of Canada's unemployed. Canadians pay into this system throughout their working lives as insurance that they will receive assistance in times of need. Principled EI payments would thus be allocated on a per-client basis, based on eligibility.

Of course, not every unemployed person would qualify for regular benefits, since the program was designed to assist an individual who experiences an unexpected layoff rather than someone who voluntarily left their position. However, it should be expected that the proportion of EI-related transfers would benefit a large majority of a province's unemployed population, closely mirroring that province's share of the nation's unemployed persons.

13 Office of the Parliamentary Budget Officer. (2018). "Status Report on Phase 1 of the New Infrastructure Plan."

ASSESSMENT

Previous Mowat research has demonstrated that Ontarians receive less EI payments than their share of Canada's unemployed. This analysis demonstrates that over the ten-year period, from 2007 to 2016, total EI payments to unemployed Ontarians was consistently below Ontario's share of Canada's unemployed over the period (see Figure 10).

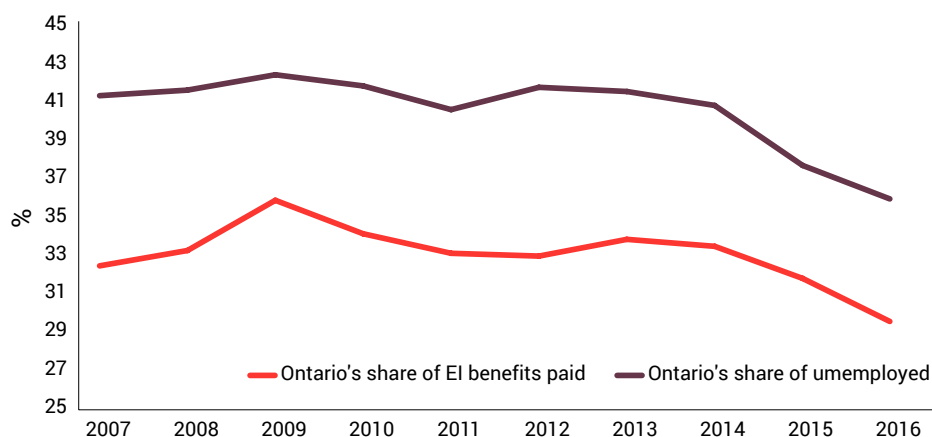
The yawning gap between what Ontarians received in EI-related spending and the province's share of Canada's unemployed reflects the reality that Ontario workers face: less than 30 per cent of Ontarians actually receive EI when they fall out of work.¹⁴

The root of the program is outdated eligibility criteria. EI allocates benefits based on local unemployment rates across 58 regions. Because many of Ontario's regions have lower unemployment rates, Ontarians must work longer to qualify for EI benefits and when they do qualify, they receive lower benefits for shorter periods of time.

However, the eligibility criteria of the EI system were conceived during a time in which most workers were employed in full-time, permanent positions. Structural changes in the economy and labour market over the past few decades have caused a rapidly increasing shift towards part-time, temporary or contract work which may not meet the "hours worked" requirements to qualify for EI. As a result, EI spending is drifting further away from the program's initial intention, and further away from a principled approach to allocation.

What if unemployed Ontarians received a fairer share of EI payments? If individual transfers for EI benefits took a truly per-client approach, total spending would match the intended client: unemployed Ontarians. To visualize this scenario, this would essentially mean raising the orange bar to match the purple one in Figure 10 below, eliminating the gap between the share of payments and recipients.

FIGURE 10
Ontario's share of the unemployed vs. share of EI benefits paid



Source: Statistics Canada Tables 282-0002 and 384-0047.

14 Statistics Canada: CANSIM Tables 276-0022 and 282-0087.

Over ten years, the amount of foregone benefits is staggering. If Ontarians received EI payments on a per-client basis, they would have cumulatively had access to \$11.8 billion in additional payments over those ten years (see Figure 11).

FIGURE 11
Foregone EI benefits in current vs. per-client EI payments, 2007 to 2016

	Ontario's Share of Unemployed	EI Payments	"Per-Client" Payments	Forgone Benefit
2007	41.4%	4,090	5,204	1,114
2008	41.7%	4,422	5,541	1,119
2009	42.5%	6,770	8,003	1,233
2010	41.9%	6,046	7,410	1,364
2011	40.6%	5,256	6,441	1,185
2012	41.8%	5,097	6,450	1,353
2013	41.6%	5,116	6,273	1,157
2014	40.9%	5,225	6,374	1,149
2015	37.8%	5,403	6,408	1,005
2016	36.0%	5,413	6,578	1,165
Total		52,838	64,682	11,844

Source: Statistics Canada. Table 384-0047 and Mowat Centre calculations

RECOMMENDATIONS

Based on this analysis, individual transfers for EI payments are not allocated fairly to Ontarians. This is one of a handful of factors that contributes to the fiscal gap in Ontario – and a rather significant one. In fact, inclusion of the \$11.8 billion in foregone EI benefits over ten years, as calculated above, would have reduced the cumulative fiscal gap of \$96.2 billion by 12.3 per cent.

A full examination of the complexities of the EI system is beyond the scope of this paper. However, there is a vast literature on the shortfalls of how the program is currently administered, and what steps can be taken to modernize the system and allocate benefits more fairly and

transparently. In addition to allocating EI benefits on a more accurate per-client basis, EI could be improved by nationally standardizing with a single national entrance requirement, benefit duration range and weekly benefit formula. Furthermore, benefits should be modified to respond to shifting economic conditions, such as the changing nature of work.¹⁵

Old Age Security

PURPOSE

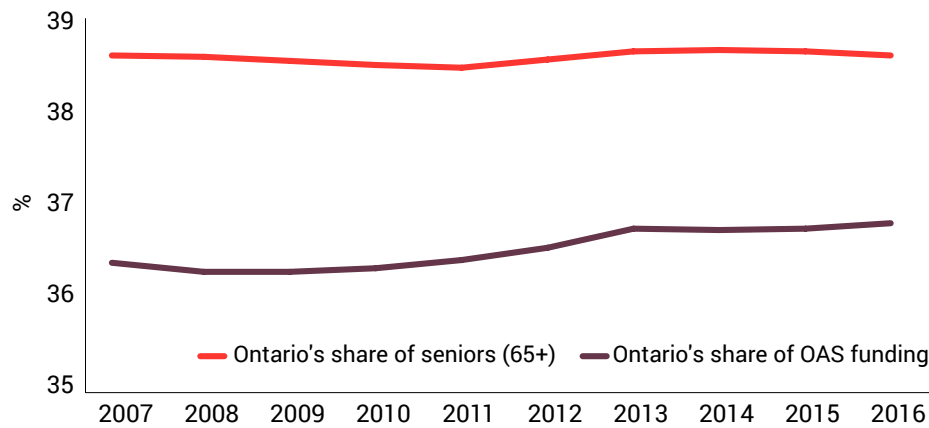
Old Age Security (OAS) is a key pillar of Canada's retirement incomes system – along with the Canada Pension Plan (CPP) and private savings vehicles such as RRSPs and employer-sponsored pensions.¹⁶ Unlike the CPP however, OAS is funded directly out of federal general revenues and transferred in monthly installments to senior Canadian citizens or legal residents over the age of 65.

The purpose of OAS payments is to support Canadians in their retirement, particularly in the absence of other income sources. As of July 2018 for example, Canadians can receive a maximum monthly payment of \$596.67 regardless of marital status. This caps out at a maximum annual income. Individuals with annual income over \$123,302 are not eligible for OAS. Individuals receiving OAS may also be eligible for the Guaranteed Income Supplement (GIS) top up, a means-tested and non-taxable benefit for low-income seniors.

15 For more on EI modernization, see: Mary Davis, Josh Hjartarson & Jon Medow (2011) "Making it work: The final recommendations of the Mowat Centre EI Taskforce." *Mowat Centre*. <https://mowat-centre.ca/making-it-work/>.

16 Grant, T. and Agius, J. (2017) "Census 2016: The Growing Age Gap, Gender Ratios and Other Key Takeaways." *The Globe and Mail*. <https://www.theglobeandmail.com/news/national/census-2016-statscan/article34882462/>.

FIGURE 12
Ontario's share of seniors and OAS transfers



Source: Statistics Canada. Table 051-0001 and Provincial Economic Accounts.

PRINCIPLE

This category of transfers directed to individuals is needs-based, as OAS aims to support those who need it most. Seniors with higher incomes have less need for an income supplement, and the formula for allocating OAS takes this into consideration, directing funds to higher need, low-income seniors.

ASSESSMENT

If one were to compare Ontario's share of the senior population to the share of OAS funding the province received from federal transfers, the gap would seem large – much like EI. However, a per-client allocation of OAS would not be the fairest or most principled approach. As a needs-based program, other factors must be considered: in this case, income level is the determining criteria of need.

Ontario seniors have the highest average income of seniors across all provinces,¹⁷ meaning that the average senior Ontarian will receive less in OAS payments than other senior Canadians. It is therefore a natural and expected outcome that in the aggregate, Ontario receives less in federal transfers for OAS payments than its share of senior population.

RECOMMENDATIONS

OAS program expenditure is allocated fairly and meets its principle as a needs-based program. The targeted population of lower-income seniors is reached as intended. Ontarians, therefore, are treated fairly by the program despite a gap between Ontario's share of seniors and its share of OAS spending.

17 Hartmann, E. and Thirgood, J. (2017) "Mind The Gap: Ontario's Persistent Net Contribution to the Federation". *Mowat Centre*. https://mowatcentre.ca/wp-content/uploads/publications/142_mind_the_gap.pdf.

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5 CONCLUSION

A look back at Ontario's ten-year contribution to the federation shows that the province is a persistent net contributor. Ontarians contribute more to federal revenue than they receive in federal spending. In 2016, this gap was nearly \$13 billion. Over the last decade, Ontarians' cumulative net contribution totaled over \$96 billion. A good deal of this gap is attributable to unprincipled allocations of federal funding that do not benefit Ontarians (see Figure 13).

FIGURE 13
Summary of assessment

Transfer	Program	Principled Approach	Assessment of Allocation	Is Current Allocation Principled?
Transfers to provincial and territorial governments	Equalization	Needs based	Ontario continues to be the only "have not" province receiving Equalization payments that is still a net contributor to the federation. This means that the program is not meeting its intended purpose of providing funds to provincial governments with low fiscal capacity.	✗
	Canada Health Transfer (CHT)/ Canada Social Transfer (CST)	Per capita	Both the CHT and CST are provided on a per-capita basis, with each province receiving transfers equal to its share of the nation's population. This means that governments receive necessary funds to provide public services to their residents.	✓
	Other transfers	Variable	Ontario receives considerably less than its per-capita share of transfers that fall into the "other" category, although a more detailed analysis of individual transfers would be required to make a comprehensive assessment of fairness.	✗
Transfers to individuals and households	Employment Insurance (EI)	Per client	There is an unjustifiable gap between its share of payments for EI regular benefit recipients and the province's share of the unemployed. This means that the program is largely not meeting the needs of the intended client.	✗
	Old Age Security (OAS)	Needs based	OAS is means-tested and geared to income, meaning that recipients of funding are those who need it most, therefore meeting the intended goal of the program.	✓

Looking forward, this trend seems likely to continue. Canada's resource-based economies continue to face difficulties, which will increase the federal government's reliance on Ontario for revenues. The growing fiscal burden on Ontario's shoulders could, however, be offset with greater fairness in the allocation of federal funding and is justifiable on a principled basis. Equalization, "other transfers" and EI are prime candidates for increased fairness.

APPENDIX

Conceptually speaking, the fiscal gap represents the difference between federal revenue collected within a province and what the province gets back in federal spending. By simply calculating this number however, you do not get the whole story. For example, the federal surplus or deficit could artificially inflate or deflate the size of a reported gap, regardless of its magnitude. A large federal surplus could create an impression that all provinces are contributing more than they are getting back, while a large deficit could create an opposite impression.

To mitigate this effect, our model adjusts both the revenue and spending sides of the equation on the assumption that the federal government is trying to balance its books. The “Balanced Budget Approach” then takes an average of two scenarios: the net contribution when revenues are set to match expenditure (plus public debt interest); and the net contribution when expenditure is set to match revenues (subtracting public debt interest). The average is what we refer to as the net contribution to the federation.

The reported figures are also adjusted to account for the Quebec Abatement, distribute federal excise tax revenue on an equal-per-capita basis, and remove any federal expenditure or revenue raised outside of Canada, such as foreign aid and the Foreign Service. The share of federal spending on public debt interest in each province is set at its share of the nation’s population.

The provincial shares of federal revenue, expenditure and public debt interest were calculated using the recent available data from Statistics Canada’s Provincial and Territorial Economic Accounts for each fiscal year from 2007 to 2016. These shares were then applied to the annual, Canada-wide, Public Accounts of Canada for those years.

