Paying for Canada

by

Sherri Torjman

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Caledon Institute of Social Policy
1354 Wellington Street West, 3rd Floor
Ottawa, ON K1Y 3C3
CANADA
Tel./Fax: (613) 729-3340
E-mail: caledon@caledoninst.org
Website: *www.caledoninst.org*
Twitter: @CaledonINST

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The expenditure side of the equation

Discussions about financing in Canada often focus on the revenue side of the equation. Federal revenues derive primarily from various sources of taxation including income tax, sales tax, payroll taxes (also known as payroll contributions) and corporate tax. The levels and mix of these taxes always seem to spark spirited conversations within and outside government. Both the volume and rhetoric heat up as elections draw near.

This report does not deal with the revenue side of the ledger. It is not about how money comes into the government and how Ottawa uses the personal income tax system to deliver income benefits – the latter a crucial subject about which Caledon has written in previous reports. We have argued for a progressive income tax system, the removal or refundability of 'boutique' tax credits that favour the well-off and restoration of the two-percentage point cut in the Goods and Services Tax (GST) [Battle and Torjman 2011; Battle, Torjman and Mendelson 2011].

Rather, this report is about the expenditure side of the equation. When revenues come into the federal coffers, these funds are allocated through several key instruments for a wide range of purposes deemed to be in the public good.

In 1993, the Caledon Institute published a report entitled *Fiscal Federalism and You*. Its purpose was to explain in simple language the arcane funding arrangements in Canada that help finance social programs [Torjman 1993]. Substantial changes have been made to those arrangements since that time. This paper presents an overview of the key shifts in that financing architecture.

The timing of this expenditure discussion is important. Three major transfer arrangements described below – the Canada Health Transfer, Canada Social Transfer and Equalization – are governed by federal legislation that is set to expire on March 31, 2014. A more recent measure, the Total Transfer Protection program (described below), will be cut altogether.

Transfers to Canadians and to governments

The federal government invests in Canada both directly and indirectly. It makes direct investments in programs that focus on groups within its own jurisdiction including Aboriginal Canadians, members of the Armed Forces, veterans and a variety of transfers to individuals. Ottawa invests in Canada indirectly through transfers to other orders of government.

Transfers to persons include payments for the elderly, children, the working poor and unemployed Canadians. These expenditures amount to $72.4 billion in 2013-14 [Finance Canada 2013]. See Table 1. Major income security programs financed by the federal government are: Old Age Security, Guaranteed Income Supplement, the Allowance, Canada Child Tax Benefit, Universal Child Care Benefit, Working Income Tax Benefit and Employment Insurance. Ottawa also administers the Canada Pension Plan, which is paid for by employer and employee contributions. Quebec operates the analogous Quebec Pension Plan.

Table 1 Program Expenses Outlook							
billions of dollars	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**
Major transfers to persons							
Elderly benefits	40.3	42.0	44.1	46.4	49.0	51.7	54.4
Employment Insurance benefits[1]	17.1	17.3	17.9	18.5	19.0	19.5	20.3
Children's benefits	13.0	13.1	13.2	13.4	13.6	13.7	13.9
Total	70.3	72.4	75.2	78.3	81.5	84.9	88.6
Major transfers to other levels of government							
Canada Health Transfer	28.6	30.3	32.1	34.0	36.1	37.7	39.3
Canada Social Transfer	11.9	12.2	12.6	13.0	13.3	13.7	14.2
Fiscal arrangements[2]	17.8	18.7	19.3	20.0	20.8	21.7	22.5
Gas Tax Fund	2.0	2.1	2.0	2.0	2.1	2.1	2.2
Other major transfers[3]	1.5	0.6	0.3	0.2	0.1	0.1	0.0
Alternative Payments for Standing Programs[4]	-3.4	-3.5	-3.7	-3.9	-4.1	-4.4	-4.6
Total	58.4	60.5	62.6	65.2	68.3	70.9	73.7
Direct program expenses							
Operating expenses	78.0	77.0	73.9	74.5	75.4	77.2	79.3
Transfer payments	34.9	38.2	35.6	35.2	37.0	37.4	38.3
Capital amortization	4.9	5.5	5.8	6.2	6.5	6.7	6.9
Total	117.7	120.7	115.4	115.9	119.0	121.4	124.5
Total program expenses	246.4	253.6	253.1	259.4	268.8	277.2	286.8

Source: Finance Canada. (2013). *Update of Economic and Fiscal Projections - 2013*. Part 3 of 4, pp. 10-11.

Table 1 (continued) Program Expenses Outlook							
billions of dollars	**2012-13**	**2013-14**	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**2018-19**
Percent of GDP							
Major transfers to persons	3.9	3.9	3.9	3.9	3.9	3.8	3.8
Major transfers to other levels of government	3.2	3.2	3.2	3.2	3.2	3.2	3.2
Direct program expenses	6.5	6.5	6.0	5.7	5.6	5.5	5.4
Total program expenses*	13.5	13.6	13.1	12.8	12.7	12.5	12.4

* Totals may not add due to rounding

Notes to the table

1. EI benefits include regular benefits, sickness, maternity, parental, compassionate care, fishing and work-sharing benefits, and employment benefits and support measures. These represent 90 percent of total EI program expenses. The remaining EI costs relate mainly to administration and are part of operating expenses.

2. Fiscal arrangements include Equalization, Territorial Formula Financing, the Youth Allowances Recovery and statutory subsidies.

3. Other major transfers to other levels of government include transitional payments; transfer protection payments in 2012-13 and 2013-14; payments under the 2005 Offshore Accords; assistance regarding sales tax harmonization; the Wait Times Reduction Transfer; and other health-related transfers.

4. Alternative Payments for Standing Programs represent a recovery from Quebec of an additional tax point transfer above and beyond the tax point transfer under the Canada Health Transfer and the Canada Social Transfer.

Payments to other orders of government are made primarily through several major funding arrangements: the Canada Health Transfer, Canada Social Transfer, Equalization and Territorial Formula Financing. Major transfers to other orders of government total $60.5 billion in 2013-14. Table 1 shows that transfers to persons and major transfers to other orders of government comprise just over half ($132.9 billion or 52 percent) of total federal program spending ($253.6 billion) in 2013-14 [Finance Canada 2013].

An additional $38.2 billion in transfers in 2013-14 is administered directly by federal departments and agencies for designated purposes, such as skills training and infrastructure development. These arrangements often require a financial contribution by the recipient government or financing partner.

In 2013-14, for example, the federal government is expected to allocate more than $2.7 billion to the provinces and territories for labour market and skills training programs. This funding is intended to supplement existing provincial funding and is delivered through several bilateral accords known as the Labour Market Development Agreements, Labour Market Agreements, Labour Market Agreements for Persons with Disabilities and Targeted Initiatives for Older Workers.

Recent proposed changes in federal financing for skills development are discussed in Caledon reports on the Canada Job Grant. This new measure would have imposed on the provinces and territories an additional cost of up to $600 million plus administrative expenses [Mendelson and Zon 2013]. In an unexpected twist, Ottawa appears to have softened its fiscal position. It made a Christmas Eve announcement in which it offered to waive the provincial matching requirement [Curry 2014].

In addition to transferring money to the provinces and territories, Ottawa funds its own labour market programs for youth, persons with disabilities and Aboriginal Canadians.

Three major fiscal transfers

Federal fiscal transfers are a crucial source of revenue for provinces and territories. These funds help maintain Canada's system of health and social programs, while seeking to reduce revenue disparities between, and within, various orders of government.

From a social policy perspective, there are three main arrangements that fund provincial/territorial social programs: the Canada Health Transfer (CHT), Canada Social Transfer (CST) and Equalization. The Total Transfer Protection program, described below, is an add-on that is calculated after the first three are determined.

The CHT and CST are the two key instruments that Ottawa employs to direct funds to provincial and territorial governments in support of major health and social programs, respectively. In 2013-14, combined national CHT and CST cash payments total $42.5 billion [Finance Canada 2013]. See Table 1.

These two transfers originally comprised one envelope called the Canada Health and Social Transfer (CHST). The CHST was created when Ottawa combined into one big bucket the former *Established Programs Financing* arrangement that helped pay for health care and post-secondary education, and the Canada Assistance Plan that had supported social assistance (welfare) and social services.

In April 2004, the federal government dismantled the CHST and created two separate pools of funds: the Canada Health Transfer and the Canada Social Transfer. The tax and cash components (described below) of the former CHST were apportioned between the two new transfers in the same ratio as overall provincial spending in the areas covered by the two transfers.

a. Canada Health Transfer

The Canada Health Transfer is the larger of the two pools of funds. Its purpose is to provide long-term predictable funding for health care. In 2013-14, total federal CHT expenditure comes to $30.3 billion [Finance Canada 2013]. See Table 1.

The CHT is intended to support the five principles set out in the *Canada Health Act*: comprehensiveness, universality, portability, public administration and accessibility. In order to qualify for the full federal cash contribution under the CHT, provinces and territories must comply with the conditions of the *Canada Health Act* which, at least in theory, prohibit extra-billing by physicians and user charges by hospitals.

The CHT payment consists of two components: a tax transfer and a cash transfer. A tax transfer occurs when, upon agreement, the federal government reduces its tax rates and provincial/territorial governments simultaneously raise their tax rates by an equivalent amount. Revenues that would have flowed to the federal government are directed instead to these other orders of government.

The tax transfer, in particular, was part of a federal-provincial/territorial arrangement that had taken effect in 1977 under the former *Established Programs Financing Act*. At that time, Ottawa transferred 13.5 percentage points of its personal income tax and one percentage point of its corporate income tax to the provinces and territories. The value of the tax point component continued to increase in line with economic growth.

As for the cash component of the equation, the total CHT cash envelope is legislated under the *Federal-Provincial Fiscal Arrangements Act*. Initially set at a fixed amount in 2004-05 and 2005-06, the total CHT cash envelope was slated to increase at a rate of 6 percent annually until 2013-14.

CHT transfer payments to the provinces are determined on an equal per capita basis according to an agreed-upon formula. Each province's share of per capita CHT cash is calculated as a residual or a remainder – i.e., the province's per capita share of total CHT less its per capita tax point transfer. Because the per capita cash transfer is higher for provinces with relatively weak tax point transfers, the CHT cash component was deemed to include an equalizing component.

This equalizing component of the CHT formula had been criticized on the grounds that interprovincial equity imbalances are more appropriately redressed through the Equalization program. In response, the 2007 federal Budget removed the equalizing component of the CHT. It legislated that the cash transfer shift to an equal per capita allocation effective 2014-15, the first year of a new agreement following the expiry of the 10-Year Plan, described below.

When the Canada Health Transfer was split off from the larger Canada Health and Social Transfer in 2004, provinces signed a *10-Year Plan to Strengthen Health Care*. The Plan identified the core areas around which greater investments were required in order to support health care renewal.

Under the *10-Year Plan*, Ottawa committed $41 billion in new, long-term funding, including a 6 percent annual escalator, beginning in 2006-07. Most of the increase ($35.3 billion) was delivered through the Canada Health Transfer. A separate payment of $5.5 billion was made to help reduce wait times and an additional $500 million was allocated for medical equipment.

The federal government also promised to invest $16 billion in a Health Reform Fund over the course of five years starting in 2004-05. The purpose of the payment, known as the Health Reform Transfer, was to accelerate change in priority areas: primary care, home care and catastrophic drug coverage.

Funds under the Health Reform Transfer were allocated to each jurisdiction on an equal per capita basis. The funding allocation over five years was $1 billion in 2004-05, $1.5 billion in 2005-06, $3.5 billion in 2006-07, $4.5 billion in 2007-08 and $5.5 billion in 2008-09. Starting in 2005-06, the Health Reform Transfer was integrated into the CHT.

The *10-Year Plan to Strengthen Health Care* is scheduled to end on April 1, 2014. Starting in 2014-15, provincial and territorial CHT transfers will be allocated on an equal per capita ***cash basis only***.

As noted, the move to an equal per capita cash allocation was part of the plan announced in Budget 2007 to provide comparable treatment for all Canadians, regardless of where they live. The federal government made a commitment at the time to ensure that no province or territory would receive less than its 2013-14 CHT cash allocation in future years as a result of the move to equal per capita cash.

Total CHT cash levels were set in legislation up to 2013-14 and were slated to grow by 6 percent annually as a result of an automatic escalator. But in December 2011, Ottawa announced that total CHT cash would keep rising at the annual rate of 6 percent until 2016-17. Starting in 2017-18, total CHT cash will grow in line with a three-year moving average of nominal Gross Domestic Product, with funding guaranteed to increase by at least 3 percent per year. The $30.3 billion CHT cash transfer in 2013-14 is expected to reach at least $39.3 billion by 2018-19 [Finance Canada 2013]. See Table 1.

But all is not well with the health care transfers. The Government of Manitoba points out that the new formula was introduced unilaterally by the federal government with no provincial/territorial consultation. It notes the implications for the future financing of health care:

> Under the unilateral federal renewal plans, annual growth in the CHT will decline significantly from the 6 percent previously set out in the *10-Year Plan to Strengthen Health Care*. Starting in 2017-18, growth in federal support will be determined by a three-year moving average of national nominal GDP, expected to be from 3 percent to 4 percent (with a minimum increase of 3 percent). The CST will continue to grow at its current rate of 3 percent per year. Both the CHT and CST are not due to be renewed again until 2023-24 [Government of Manitoba 2013: D3].

The January 2012 meeting of the Council of the Federation, comprising provincial and territorial Premiers, also expressed concern about this shift. The Council had appointed a Working Group on Fiscal Arrangements to explore the impact of the federally announced change. The Group's findings were highlighted in a statement released in 2012 [Council of the Federation 2012]:

> For health, the federal government's Canada Health Transfer (CHT) will be reduced by almost $36 billion, in total, over the 10-year period from 2014-15 to 2023-24 compared to the arrangements currently in place. This will bring the federal share of health care costs to less than 20 percent, compared to about 50 percent originally.
>
> In the shorter term, the 5-year period from 2014-15 to 2018-19, provinces and territories will receive, in total, about $23 billion less than under the current arrangements, with the CHT accounting for about $7 billion of the reduction and Equalization accounting for about $16 billion. The Working Group did not estimate Equalization implications beyond 2018-19.

Manitoba argues that the 2011 federal announcement, made more than two years before the 2014 renewal date, by-passed an opportunity for consultation, collaboration and co-operation between the two orders of government. These factors have historically been critical to the success of the Canadian federation and to the development of effective transfer arrangements [Government of Manitoba 2013: D4].

Ontario, in particular, will take a hit from the shift to equal per capita cash. As noted, Ottawa had made a commitment to ensure that no province or territory would receive less than its 2013-14 CHT cash allocation in future years as a result of the move to equal per capita cash. Ontario Health Minister Deb Matthews has expressed anger about the fact that the federal government "betrayed Canada's most populous province by breaking their promise over health care funding" [Babbage 2013]. Ontario will receive the equivalent of only a 3.4 percent increase in 2014-15. Alberta, by contrast, will be gaining about $1 billion more – the equivalent of a 38 percent rise in that year.

b. Canada Social Transfer

The Canada Social Transfer (CST) is a financial transfer to provinces and territories in support of post-secondary education, social assistance and social services, early childhood development, and early learning and child care. The CST has been paid out on an equal per capita basis since 2007-08. Its purpose is to ensure relatively equal support for services throughout the country. Prior to that time, the CST payment included cash as well as a tax component, similar to the current Canada Health Transfer allocation.

The CST base increased by $687 million in 2007-08 in order to support the provision of equal per capita cash. In 2008-09, the CST grew by $800 million for post-secondary education and an additional $250 million to enhance the development of child care spaces.

CST cash levels are currently set in legislation up to 2013-14 and have grown by three percent annually as a result of an automatic escalator applied since 2009-10. In December 2011,

Ottawa announced that the CST will continue to grow at three percent a year effective 2014-15 and beyond. The CST cash transfer totals $12.2 billion in 2013-14 and is slated to reach $14.2 billion by 2018-19 [Finance Canada 2013]. See Table 1.

c. Equalization

Equalization payments represent the third major transfer in Canada. Their purpose is to ensure that all provinces have the financial capacity to offer their residents reasonably comparable public services at reasonably comparable rates of taxation.

> Equalization payments play an important stabilizing role in Canada; they guarantee that all regions of the country have relatively equal ability to finance basic services. Equalization ensures that all provinces can support the infrastructure – including roads, sewers, garbage collection, police and fire services – required to build and maintain a minimum standard of public services in both urban and rural communities. By significantly reducing the disparities in the fiscal capacity of provincial governments, these payments help minimize the extreme disparities in services that likely would occur in the absence of the Equalization program [Torjman 1993: 2].

The role of this transfer is seen as so important that its objective is entrenched in the Canadian Constitution. It states that: "Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" [Subsection 36(2) of the *Constitution Act*, 1982].

In the absence of Equalization, Canadians in less wealthy provinces would face higher debt, lower levels of public services and/or higher levels of taxation than Canadians in more wealthy provinces.

It should be noted that there is a separate, but similar, program in place for the three territories – Yukon, the Northwest Territories and Nunavut. The Territorial Formula Financing (TFF) program is an annual transfer from Ottawa to the three territorial governments to enable them to provide a range of public services comparable to those offered by provincial governments, at comparable levels of taxation.

The Territorial Formula Financing helps territorial governments fund essential public services in the North, such as hospitals, schools, infrastructure and social services. It recognizes the high cost of providing public services north of 60 as well as the challenges that territorial governments face in delivering these services to a large number of small, isolated communities.

This report focuses upon Equalization payments to provinces. In order to determine appropriate levels of payment, the program calculates, on a per capita basis, what each province could raise on its own at typical rates of taxation. Any shortfall relative to this "10-province standard" is paid out in Equalization. Payments are also adjusted to keep the total program payout growing in line with the economy.

In 2013-14, six provinces are currently receiving a total $16.1 billion in Equalization payments:

- PEI $340 million
- Nova Scotia $1.46 billion
- New Brunswick $1.51 billion
- Quebec $7.83 billion
- Ontario $3.17 billion
- Manitoba $1.79 billion

Adjustments to the Equalization formula have been made along the way to reflect both revenues and major distortions – from a national perspective – to which those revenues may give rise. The Equalization formula was altered in 1982, for example, as the result of an imbalance related to the large increase in oil and gas revenues in the Western provinces.

Previously, the Equalization formula had taken into account the revenue-raising capacity of all the provinces. Alberta's revenues subsequently were dropped from the equation in order to reduce distortions resulting from big gains in energy revenue. To help offset this shift, the Atlantic provinces were eliminated from the base calculations as well.

In addition, the growth in total federal payments was capped. These could not rise above the level of Equalization payments in the 1982-83 fiscal year by more than the increase in Gross National Product. Adjustments have also been made with the Atlantic region through the Atlantic Accords for Nova Scotia and Newfoundland and Labrador.

The calculation of resources within the formula remains an issue to this day. The current formula allows provinces to get the greater of the amount they would receive by fully excluding natural resource revenues, or by excluding 50 percent of natural resource revenues.

Other recent changes include the introduction of the Total Transfer Protection (TTP) program. It was announced by the federal government in 2010 to help provinces address the fiscal challenges related to the 2008-09 recession.

The purpose of the TTP was to ensure that no province receives less in combined major transfers (CHT, CST and Equalization) than it did the previous year. If the Equalization formula – combined with health and social transfers – produced a total reduction in transfers for a province, then Ottawa would step in to cover the loss. If a province's economy improved or if its population declined, the TTP payment would help offset the associated decline in transfers.

Since its inception, the program has paid out more than $2.2 billion to seven provinces, including Newfoundland and Labrador, Prince Edward Island, Nova Scotia, New Brunswick, Quebec, Manitoba and Saskatchewan. In 2012-13, Ottawa provided transfer protection of $680 million to Nova Scotia, New Brunswick, Manitoba and Quebec. In 2011-12, Ottawa directed a total of $952 million to Nova Scotia, New Brunswick, Manitoba and Quebec. In 2010-11, the transfer protection payments totalled $525 million and were paid to Newfoundland and Labrador, Prince

Edward Island, Nova Scotia, New Brunswick, Manitoba and Saskatchewan [Curry and Morrow 2013].

While the TTP was extended into 2013-14, its pending demise was announced by the Finance Minister in December 2013, much to the dismay of the provinces – Ontario, in particular. Prior to the December 2013 announcement of its termination, few Canadians even knew that the program existed.

A perfect example of policy stealth [Battle 1990], reference to the TTP was found primarily buried in footnotes to major Budget entries. It was essential to read the subscripts in order to see that $2.2 billion had been paid through this program in addition to the nearly $60 billion that Ottawa had transferred to the provinces since 2010 [Gunter 2013].

Ontario will be the big loser from the announced change. The Ontario Finance Minister was "infuriated" to learn that the Equalization funding to Ontario for 2014-15 would be $19.2 billion – down $641 million, or 3.24 percent, from this year's $19.8 allotment [Benzie and Boutilier: 2013]. The province is facing a loss in the first place because Equalization is based on a three-year average of economic growth; the Ontario economy has strengthened since the recession, leading to lower Equalization payments.

The coming year would have been the first in which Ontario qualified for a payment under the TTP program. But there will be no TTP assistance in this case.

Ottawa, for its part, argues that the Total Transfer Protection program was intended only as a temporary measure to help provinces and territories "in transitioning through current economic challenges." In Manitoba, for example, the TTP payments have played an important role in helping stabilize its year-over-year revenues following the recession in 2008 and 2009, and the major flood it experienced in 2011 [Government of Manitoba 2013: D2].

But some observers have questioned the timing of the TTP cut – especially when Ontario is about to enter into full-swing election mode [Mendelsohn and Zon 2013]. The revenue loss will not be seen well by credit rating agencies or by Ontario taxpayers who will have to make up the revenue loss.

Ontario contends that there had never been a conversation or dialogue with Ottawa as to when this transfer protection would end. There is usually a warning or heads-up to give provinces some lead time to absorb the shock of – and prepare for – these types of seismic fiscal shifts.

Conclusion

There is likely no public policy topic more arcane (or dull) than fiscal transfers. Yet they are crucial to understand and to track. Their impact upon the quality of life of Canadians is nothing short of profound. Fiscal transfers are the way that Canada pays for the benefits, amenities and protections that effectively comprise this country.

Budget 2014 doubtless will reiterate many of the recent announcements and changes already introduced. Provinces and territories, for their part, are hoping for no more surprises as the February Budget draws near.

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