TD Bank Financial Group

TD Economics

Special Report

August 24, 2009

HOW ARE WE DOING ON SOCIAL POLICY? IS THE RECESSION PARALYZING OR TRANSFORMATIVE?

The following reflects remarks delivered by Don Drummond at the conference "Social Policy and the Recession: A passive or transformative response?" organized by Queen's University's School of Policy Studies on August 17-19, 2009

While the recession may technically draw to a close in the third quarter, its reverberations will be felt for some time. Most notably, recovery will be sluggish relative to that in the wake of past recessions. Unemployment will continue to rise into 2010 as re-hiring proceeds slowly and more workers enter the labour force. A slower pace of trend economic growth also means greater stress on government budgets. The pace of government spending will have to be lowered in the near future or there will be ongoing structural deficits.

These are indeed substantial challenges, but such stresses may nonetheless shape a "transformative" response. Here, a "transformative response" is defined as an evolution of social programs so as to better respond to present circumstances and to better support economic performance in the longer-term. This contrasts with a "passive response" in which policy-makers stick with present program designs, with the faith that these will respond adequately during the present downturn and that demand will ease as economic normalcy is restored.

Diamonds form under pressure

In order to understand how a recession might be transformative, we should consider how a recession interacts with social programs:

First, the efficacy of existent income support programs is tested and, with increasing demand, their flaws are highlighted. It is desirable that government provide "social insurance" that a market would not provide as a result of informational asymmetries. Our present income support framework for working age adults consists of two main programs: Employment Insurance (EI), which provides wage replacement for workers who face an unexpected job loss; and social assistance (or "welfare"), which provides a subsistence level of income support. Both have significant design flaws that are being highlighted during the present downturn.

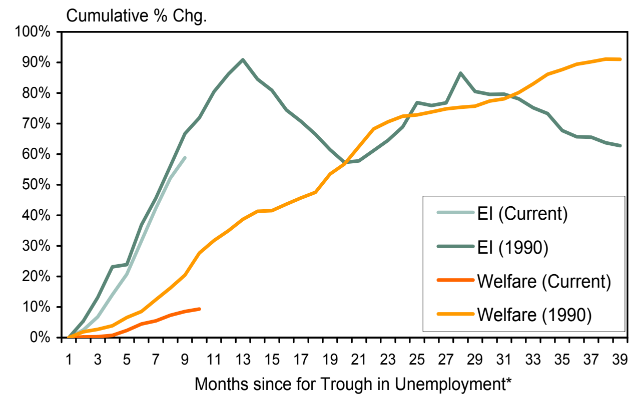
In the case of Employment Insurance, access to benefits and the duration of benefits are both tied to the regional unemployment rate. However, during a period when jobs are being shed, the unemployment rate will not accurately reflect laid-off workers' probability of re-employment. Coverage in initially low unemployment regions could be insufficiently long or wide.

In the case of Social Assistance, poor design makes welfare "hard to get on and harder to get off". Asset limits in Ontario are a particular barrier. These force individuals to exhaust savings in order to receive income support and create persistent problems for the longer-term.

Yet, while we can identify design flaws, we will only be able to quantify their full extent as high unemployment wears on, and as we see EI benefits being exhausted and welfare caseloads rising. While there have been policy changes since the 1990s, that recession provides a precedent for such a flow-through.

Second, government coffers are already being stretched by heightened expenditures and falling revenues. The

EI AND WELFARE BENEFICIARIES IN ONTARIO DURING 1990-1 AND 2008-9 RECESSIONS



Source: Ontario MCSS, Statistics Canada
* April 1990 & August 2008

stimulus fad has overtaken Canadians' previous allergy to deficits, but this trend will surely reverse. Governments will be obliged to balance their books and political pressures may mount to cut-back on social spending. Funding constraints will place a premium on social programs with good designs that fulfill policy objectives while minimizing fiscal burden.

Third, the importance of social policy to long-run economic well-being could be underscored, compelling us to bury antiquated notions of a social/economic policy divide. Against the backdrop of the cyclical downturn, there are certainly longer-term, structural trends at play. The danger is that policy-makers will mistake longer-term trends for transient conditions, and neglect to re-think how social policy supports a competitive economy. In particular, the contraction of employment in Canada's manufacturing sector will not be reversed any time soon. We cannot compete based on per hour labour costs with the still cheap but increasingly skilled workers in emerging markets. Indeed, manufacturing's longer-term prospects demand higher productivity firms and more skilled workers. Supporting incomes of laid-off workers must be a near-term goal, but we cannot blind ourselves to the need for those laid-off workers to re-train. Part of social policy is providing opportunities and incentives for a higher quality labour force. The somber growth outlook for developed economies impresses this need to construct social programs as key ingredients for long-term economic performance.

The cocoon hasn't hatched

Having outlined how a recession could prompt a "transformative response", the question is then whether social policy in this recession has been passive or transformative: The short answer is that we're not yet in transformation – we're largely letting flawed but existent income security do the present lifting. However, citizens and governments have recognized the need for transformation. Putting a finger to the wind, one gauges a consensus on enhancing program effectiveness, on ensuring fiscal sustainability and on boosting economic growth. The devil will be in forging a consensus on the details and the delivery.

Amid the din of politics-as-usual, there are nonetheless some glimmers of innovative re-thinking of social policy. It is instructive to examine social spending items from this spring's budgets.

After a political thriller of a December, the federal government brought forward a revised budget. Among the items, it included:

- An enhanced Working Income Tax Benefit (WITB) with an enhanced phase-in rate of 25% (up from 20%) and 40% increase in the maximum benefit to $925 (from $525);
- Extended EI regular benefits by 5 weeks and work-sharing agreements by 14 weeks;
- Freezing EI premium rates for 2010;
- Increased training benefits for both those inside and outside EI;
- Increased health, social and skill-training spending for Aboriginals;
- $2.1bn in social housing spending – particularly targeted for the disabled, aboriginals and seniors.

Beset by falling revenues, many provincial governments were "treading water" on social and health spending; however, there were some notable exceptions. Specifically, Ontario's budget reduced the lowest personal income bracket ($0-$36,848) tax rate by one percentage point and increased the Ontario Child Benefit (OCB). As well, Ontario merits credit for longer-term thinking in moving on a poverty reduction strategy that mandates reporting of poverty indicators – many of which are certain to worsen as unemployment remains high. As well, B.C.'s budget maintained annual 5% increases of the Low Income Climate Action Tax Credit until 2011 (at its maximum for individuals with <$30K and families with <$35K); and Quebec's budget increased the allowable deduction for childcare expenses. Many provincial governments also heightened funds for the acquisition and retrofit of social housing properties – following from the federal matching initiative.

There are also two important thrusts underway on income security: First, recognizing the dearth of retirement savings and workers' falling coverage by Employer Pension Plans (EPPS), Alberta and B.C. are pushing for mandatory (with opt-out) contribution pension funds and Ontario supports the concept (if not the precise plan). A study of retirement income support involving all Canadian governments appears likely to get underway soon. With private pensions strained by losses, provincial governments have amended pension legislation on the funding timelines for unfunded liabilities as a "band-aid".

Second, the Conservative-Liberal six-member panel on Employment Insurance is presently examining reforms to EI that would enhance benefit access and duration during the downturn. The provincial and territorial first ministers have endorsed the concept of some nation-wide standards, but could not reach a consensus on precise reforms (the Western premiers favouring a three-way urban/rural/remote differentiation, Ontario advocating a single national standard and the Atlantic premiers adamant that no reform can impair coverage in their provinces).

This downturn has upped the urgency of better income security for working age adults and for retirees. Government actions to enhance retirement savings and build income support programs that promote labour force attachment are steps in the right direction.

The Social/Economic Policy Nexus

Going forward, it is important that we have the right framework for thinking about the nexus between social and economic policy. Social policy has been viewed in tension with economic policy. The classical view is that social programs create distortions since government spending must be financed and taxation typically involves some dead-weight loss (though not in the case of corrective Pigouvian taxes). The new view is that there is a positive role for government in mitigating market failures and providing public goods.

From an economist's perspective, optimal social spending supports longer-term growth rather than being a continual drag on the economy. This requires: 1) that social spending not create distortions, but rather works to correct potential market failures; and 2) that the tax mix minimizes dead-weight loss. While distributional consequences are certainly important, a greater focus of social spending should be on growing the pie rather than competing over its divisions. Broadly then, economic goals for social programs are income growth, healthy communities, individual opportunity and life-long well-being.

A typical early stage in a policy transformation is a "sea change" in the thinking and language of policy makers around social programs. We are observing this now. It is manifested in two ways:

Firstly, policy makers increasingly speak – both internally and in public – about "incentives" and "economic returns" when diagnosing problems and designing programs. For instance, 10 years ago, the concept of high marginal effective tax rates inherent in social assistance was a somewhat arcane topic, discussed by only a handful of labour economists. However, as evidenced by the WITB, the concept has increasingly percolated into usage by government in designing and communicating the design of programs. Similar language is witnessed in (certain) current discussions around EI, as well as possible housing benefit programs. The focus on economic development and educational investments in aboriginal leaders' anti-poverty advocacy is another example of this shift. Recently elected Assembly of First Nations National Chief Shawn Atleo has been particularly emphatic about the importance of learning, arguing that "Once an instrument of oppression, education must now become the tool that brings hope, opportunity and success to First Nations."[1]

Secondly, governments increasingly distinguish "social investments" from other program expenditures - at least conceptually if not in their accounting. This is most evident in governments' terminology of "investments in" (rather than "spending on") education. In particular, for post-secondary education, there appeared an important shift in consensus during the early 2000s towards the long-run productivity benefits of heightened post-secondary education (PSE) investment and away from the 1990s view that cuts to PSE had to be part of combating deficits. A similar movement is underway with reference to the social and economic benefits of investments in early childhood education.

From Social Policy to Economic Growth

Again, a "transformative" response should place social policy as a centerpiece of strategies to boost economic performance. The growth issue (especially with reference to the growth of labour productivity) is one in which social planning goals should increasingly dovetail with economic goals: higher productivity means greater income for each hour worked, supporting higher living standards.

Economies can be thought to grow in three broad ways:

- They increase their population;
- They invest– either in more physical capital or through higher quality human capital; and
- They innovate – which can mean either better technology or streamlining how factors are used.

For a developed economy, which is near the "technological frontier", human capital and innovation are increasingly important. Social policy can then support growth by encouraging workers' acquisition of skills, promoting socially-desirable risk-taking, and facilitating well-functioning labour markets.

These point to three targets for social spending: Social investments, social insurance and social inclusion. Where social returns exceed private returns, social investments provide the efficient "top up". In particular, such social investments are well-applied to public infrastructure and education.

Well-designed social insurance ideally promotes labour market attachment while mitigating "market failures". That is, social insurance compels socially-beneficial coverage where asymmetries of information might otherwise thwart the existence of that insurance. Mandatory employment insurance or public pensions are classic examples.

Better social inclusion facilitates economically-beneficial social interactions. Recent research on social interactions and well-being has highlighted the importance of trust between citizens in minimizing transactions costs and boosting life satisfaction.[2] By enhancing workers' knowledge of labour markets, social inclusion also enables better matching of workers to particular jobs.

More specifically, we can relate this triad of investment, insurance, and inclusion to social policy challenges that face Canada. The goal should be to address root problems with designs that minimize distortions and consequent dead-weight loss. Three example areas are: 1) Promoting human capital acquisition; 2) Mitigating income inequality and insecurity; and 3) Addressing economic and social exclusion.

Boosting Educational Attainment

Educational attainment has a direct impact on individual earnings, and consequently income distribution – particularly as this skill premium widens. Moreover, non-market benefits accrue through improved health outcomes (although latent characteristics may upwardly bias such estimates) and lower reliance on social programs.

Recent empirical evidence on schooling yields substantial social rates of return – that is, those returns to society broadly in excess of private returns accruing to an individual. Private returns to education in Canada, estimated at 8 to 10%, are indeed substantial.[3] In addition, studies posit social returns of 6 to 9% occurring through innovation, knowledge spillovers, nonmarket benefits and growth in tax revenue.

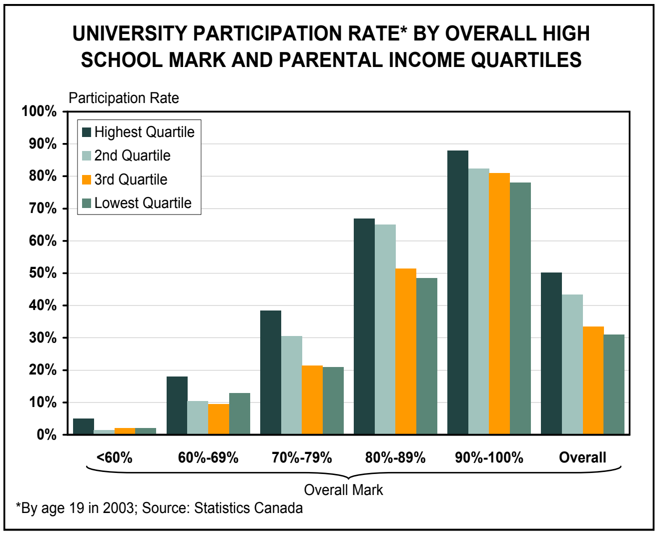
Yet, over the past decade, Canada's education expenditures have declined relative to other developed countries. In particular, Canada is at the bottom of public expenditures on early childhood education relative to OECD peers.

However, outcomes are more important that expenditures. For educational outcomes, as Riddell (2007a) observes, we must examine attainment, achievement and skills relative to our international peers. These are mixed: we show solid average performance but, when the distribution is considered, our results are more sobering. On attainment, we underperform the US at both the bottom (fewer high school grads) and the top (fewer university graduates) of the distribution. Our high school completion rates remain 25% below the OECD average – and lack of completion has been particularly exaggerated among males. While the present share of PSE graduates in the population remains high, Canada's rate of PSE graduation has fallen below the OECD average.

On achievement, depending on the assessment tool, Canadian elementary and secondary students are mid-pack or near the top of our OECD peers in standardized math and science assessments.

On skills, adult Canadians near the top quartile of the distribution perform better in literacy than their international counterparts. However, the bottom quartile under-performs their international peers. Low-literacy and numeracy disproportionately impacts older and less-educated Canadians, aboriginals and immigrants.

For post-secondary education, attainment remains unequal between children across the parental income spectrum. University participation rates range from over 50% from children of the highest income quartile to 30% from the lowest quartile. Even for students with A+ high school averages, there is a 10 percentage point gap in participation between the highest and lowest income quartiles.



The highest priority goals for educational investment are: 1) to ensure that every student (especially those most at risk) has an adequate start; and 2) to maximize opportunity for educational attainment.

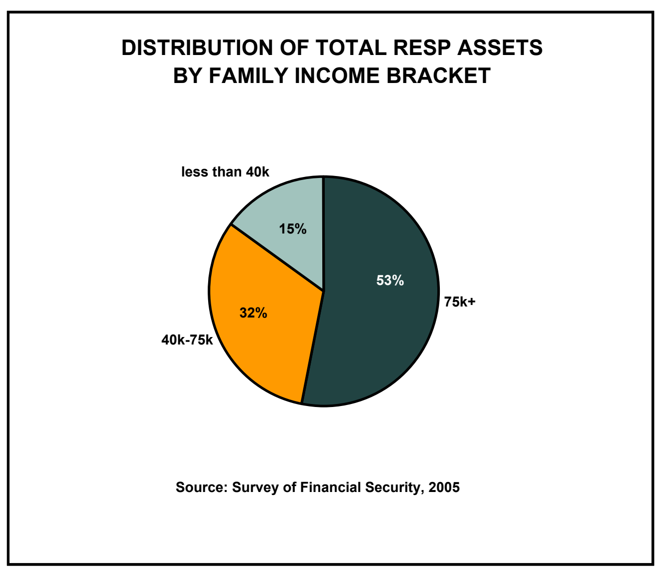
Empirical evidence supports the importance of early learning and mastery of fundamental competences in later skill acquisition.[4] As Riddell (2007a) and Trefler (2004, 2008) argue, investment in early childhood education has potential to improve educational outcomes broadly.[5] Moreover, such social investment on early childhood education (ECE) avoids more expensive remediation later on and yields substantial social returns through other channels (higher productivity, improved health outcomes, and reduced crime). However, being conscious of cost, interventions would be better targeted at those children at greatest risk of falling behind, rather than extended universally. Moreover, such ECE programs must be carefully designed in order to avoid perverse, unintended outcomes (such as the deterioration in child development outcomes and parental well-being that are reported by Baker et al. [2005] in relation to Québec's initial roll-out of child care subsidies[6]).

Pushing the "technological frontier" forward requires a labour force with the capacity to innovate and interface with technology. Greater attainment of higher quality post-secondary education will become increasingly important to Canada's economic progress. With its differentiated programs and substantial private returns, individuals will continue to bear some of the costs of their post-secondary education. But there are substantial public returns to an educated workforce, as well as an interest in equality of opportunity across the income distribution. To this end, we cannot afford that willing and qualified students from low-income backgrounds would be dissuaded from desirable programs by the "sticker shock" of tuition or would be inhibited by a lack of financing.

One approach is to place the onus on the student's family. However, registered education savings plans (RESPs) have been ineffective in mitigating "liquidity constraints" for low- and moderate income students. Participation in RESPs is concentrated in high- income, high-wealth, and high-education families, running contrary to the program's stated redistributive goal.[7] Only 15% of funds in RESPs are held by households with <$40K income (households with >$75K hold 53% of RESP funds). While 30% of children with parental income over $80K are RESP beneficiaries, beneficiaries are only 0.3% and 2.7% of children with parental incomes of <$30K and $30K-$50K, respectively.

Low-income children, whose access would be most impaired, are not benefiting from RESPs. As a result of the greater uptake of universally-available educational incentives by upper-income families, once one accounts for all government education-related transfers (including those through RESP tax-reductions), average transfers to the students from the lowest income quartile are only marginally higher than those to the highest income quartile.[8] The uptake of education tax credits is particularly skewed towards upper-income households, and appears to have a limited impact on student behaviour – in particular, on decisions by low-income students to undertake PSE.[9] There is a public interest in equality of opportunity, and shifting the responsibility to parents doesn't seem to safeguard access.

Troublingly, support for PSE education across Canada



appears to become less progressive. Despite the goals of the Canadian Millenium Scholarship foundation, in most provinces, students from families with above median incomes receive almost 60% of all benefits, while students in the top income quartile appear to receive over 33% of all new benefits. Only the governments of Canada and Ontario give even half of their new benefits to students from below median income households.[10]

With rising tuition, the lack of access to loans represents a potential barrier to post-secondary education that might well result in under-investment – particularly for liquidity-constrained low- and moderate-income students. Indeed, certain professions have widely differing distributions of private (and social) returns for the same field of study.

Two responses are: 1) Income contingent loans, reducing an individual's risk for investing in their human capital; and 2) Targeted merit-based grants to students from low- and moderate-income families. The latter has the advantage of promoting secondary school achievement and fostering competition between post-secondary institutions for high quality programs. Given the complexities of financial aid administration (which overlaps multiple governments, institutions, and foundations), governments must better coordinate administration and actively direct information to potential students - especially those at risk of not undertaking PSE.

Including the Excluded

The economic exclusion of two groups in particular calls for a social policy response: immigrants and Aboriginal Canadians.

Faced with labour market shortages – particularly in certain skilled occupations – employers should have a particular interest in promoting workplace diversity and inclusion. Large pools of our labour force are being under-utilized, and firms that can tap into talent will be well-poised to succeed. Assembling and disseminating labour market information – both to employers and workers – remains a challenge. The recent panel on Labour Market Information made a number of recommendations to address such knowledge gaps – particularly with respect to immigrant and aboriginal workers.[11]

A Home for Newcomers

With a declining birth-rate, Canada has increasingly looked to immigrants as the source of labour market growth: migration presently accounts for 84% of Canada's annual population increase. By 2011, Statistics Canada projects that all of Canada's labour force growth will rely upon immigration. The social and economic importance of integration of recent immigrants into the Canadian labour market cannot be overstated.

However, the under-performance of recent immigrants has been well-documented, despite higher average educational attainment (37% of recent immigrants 25-55 years old holds a university degree, compared with 22% of their Canadian-born counterparts).[12] Indeed, the employment rate and wage gaps have continued to widen for recent immigrants. In the 2006 census, the unemployment rate of recent immigrants was four-fold that for their Canadian-born counterparts. Foreign-acquired education and experience are severely discounted, pointing to employers' inadequate information about the quality of skills acquired in a foreign setting.[13] As well, the probability and persistence of low income status has increased for the most recent arrivals.

As factors in this under-performance, surveys of recent immigrants identify: lack of knowledge of one official language; lack of Canadian work experience; lack of knowledge of local labour markets; and lack of credential recognition. Although inconclusive, certain research demonstrates negative impacts of living and working in a homogenous ethnic enclave on recent immigrants' employment outcomes[14] while other research shows that the direction and degree differs across immigrants from ethnic groups.[15] There is also indication that ethnic settings may accommodate low-skilled, recent immigrants by providing entry-level employment.[16] However, a critical question is whether workers stagnate within ethnically homogenous settings, which might inhibit acquisition of fluency in official languages and limit access to broader labour markets.

We must also be attentive to the preparation of immigrants for the Canadian labour market. Part of this is selection within the point system: While a link with an employer or possession of "in-demand" occupations are definitely pluses, greater emphasis should be placed on the competencies that enable sustained success in procuring Canadian employment or succeeding as an entrepreneur. In particular, we need to better marry selection with advance recognition of foreign credentials.

However, we must be attentive to the evidence of discrimination as a factor in lagging immigrant outcomes. Particularly notable is the recent research by Oreopolous (2009), who submitted mock resumes to online job postings for hypothetical immigrants and Canadian-born workers.[17]

On these resumes, the author varied names as well as geography of experience and education, and recorded the interview request rates. The experiment found that employers were significantly more responsive to English-named applicants and those with Canadian experience. Countering discrimination (be it unconscious or conscious), and promoting recognition of foreign credentials and experience must be policy priorities.

These obstacles to immigrant success point to four avenues to improve outcomes:

- Greater emphasis in Canada's immigration point system on key competencies and advance credential recognition;
- Enhanced job matching and language support for recent arrivals, as well as targeted orientation to sources of labour market information in Canada;
- Federal coordination of credential recognition and pressure on self-regulating professions to publish guidelines for credential recognition; and
- More geographically integrated cities to counter risks of ghettoization.

A Canada for Canada's First Nations

Aboriginal people have experienced chronic economic and social exclusion. With 50% of Canada's Aboriginal population under 30 years old, the educational attainment and labour market integration of this group are of great importance to Canada's economy. While unemployment among aboriginals fell during 2001 to 2006, the gap with their non-Aboriginal counterparts remained large at 8.5 percentage points, and joblessness for Aboriginal youth (<25 years old) remains especially high.[18]

On-reserve employment rates are especially low, and Aboriginals living on reserves face heightened incidence of poverty and lower high school completion rates. Off-reserve Aboriginals also experience heightened unemployment (for 2007, 10.6% for off-reserve Aboriginals compared with 5.9% for non-Aboriginals), lower participation rates (for 2007, 77% for aboriginals aged 25-54 versus 87% for non-Aboriginals) and had substantially lower wages than non-Aboriginals (for 2007, 12% lower). For aboriginals, educational attainment has a great narrowing effect on the employment rate gap with non-Aboriginals. However, gaps in employment and wages persist at all levels of education: even for Aboriginal employees of 25 to 54 years of age with a PSE qualification, average hourly wages in 2007 were over $2.50 less than average wages for their non-Aboriginal counterparts.

Current provisions of the *Indian Act* certainly hinder business-related borrowing and bias activities on reserves towards parasitic industries, inhibiting entrepreneurship and broader economic development. While reserves are often geographically removed from major economic hubs, resource development in Canada's north provides one potential avenue for economic development. In order to take full advantage of resulting business opportunities, policy should focus on promoting skills development and entrepreneurial know-how among on-reserve Aboriginals.[19]

For off-reserve aboriginals, promoting educational attainment must be a priority. There is some empirical evidence is that Aboriginal students fare better in integrated schools with a mix of socio-economic background rather than in schools where aboriginal students are concentrated.[20] However, such estimates may not adequately control for the confounding differences in funding or teacher quality between schools. Qualitative studies show that Aboriginal students (as other students) fare best where parental involvement is promoted and administrators are attentive to data on student performance.

Income Security for Working Adults and Retirees

Despite strong labour markets, the 2000s witnessed widening income inequality and rise of non-standard work (that is, non-permanent, non-full time). Income security for working age adults is an incomplete patchwork of programs.[21]

Current welfare programs typically involve high marginal effective tax rates – often above 80%, resulting from the clawback in benefits as workers make the transition from welfare to work. This highlights a poor program design that discourages labour market attachment and progression to full-time work.

Canada's income security programs for children and seniors have had substantial success in the last decade and are a model for the design of income security for working age adults. Following from Stapleton (2008), these follow a three-component design of:

- A base benefit (a minimum guaranteed supplement)
- An income-tested benefit (a incentive-compatible supplement that raises overall income as earnings increase)
- Registered tax-savings instruments (to promote "self-

insurance" for a future event)[22]

To this end, the Working Income Tax Benefit (WITB) is an important innovation, acting as an income-tested benefit, but could use better integration with social assistance. For instance, by increasing the starting point at which the WITB is phased-in in Ontario, the benefit could be focused to provide its maximum benefit to full-time, low-income workers, thereby promoting the move from part-time to full-time work.

The Federal government's TFSA could also be better used to promote precautionary saving and "self-insurance" among low-income workers. In Ontario, the application of asset limits for social assistance to TFSAs inhibits participation in such saving by marginally-attached, low-income workers.[23] Raising asset limits with respect to TFSAs and allowing contributions to be deducted against the 50% earnings component could encourage the use of TFSAs as "self-insurance". Moreover, encouraging saving behaviour by low-income workers would improve their financial inclusion and preparation for old age.

Housing benefits would be well separated from welfare and administered through an income-tested housing benefit.[24] One formula for a proposed housing benefit in Ontario would fund 75% of shelter costs between a floor (defined as 30% of household income) and ceiling (an average rent).[25] This ensures a marginal cost to the recipient, but enhances housing affordability as additional income is earned.

Alongside such income security reforms, the present EI program would be better constituted on insurance principles, so as to provide *temporary* income stabilization when faced with *unexpected* job loss.

With such an important program as EI, it is disheartening to a dearth of solid reform proposals in the current debate: The Conservatives have not offered proposals to change a system with a host of flaws. The Liberals have selected an eligibility threshold that would pose major incentive problems if maintained for the longer term and doesn't rectify inter-regional disparities in the duration of benefits. The western premiers have proposed an urban/rural/remote split that has no basis in the relative employment prospects faced by a given worker, and appears as intended to preserve EI as an implicit subsidy for seasonal work.

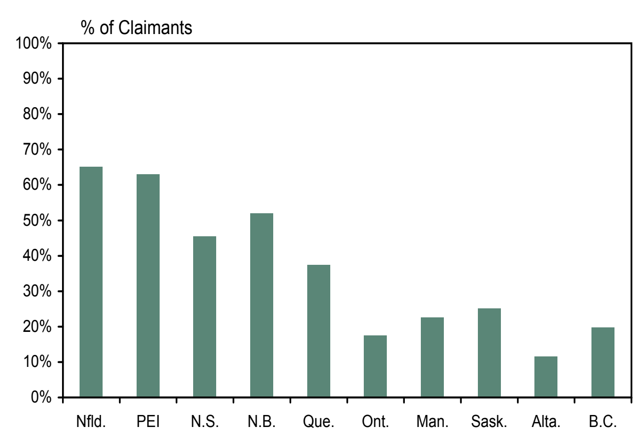
Calls for the elimination of the two-week waiting period should be resisted: this would be expensive and would not expand access in the most relevant manner (since the only who would benefit are those who are re-employed within two weeks or before their benefits expire), instead flooding the system with these transitionally unemployed. The focus of EI reform should be on addressing inequitable differences in benefit eligibility and duration between regions, while maintaining the incentive compatibility and long-run funding neutrality of the system. This includes ensuring that EI premiums do not contribute to structural unemployment. As well, the present rate-setting mechanism should be amended to fund EI liabilities across a "business cycle" so that higher premiums are not required during economic downturns.

We have recommended a short-term "flattening" of EI benefit structure so as to extend the same eligibility threshold and schedule for benefit duration to workers in all regions with less than 10% unemployment. For the longer-term, we have recommended the use of better measures of workers' probability of re-employment as the basis for differentiation of eligibility and benefit duration.[26]

Some regional differentiation of access and benefit duration may be appropriate. This insures against temporary, region-specific shocks (an exodus from a temporarily high unemployment region would be needlessly costly to individuals and society). However, EI coverage should nonetheless be based on a worker's probability of re-unemployment rather than the unemployment rate alone.

The EI program experiences high repeat use – particularly in persistently high unemployment regions. In 2007, 37% of nation-wide EI beneficiaries were frequent users (defined as having more than 3 claims in the past 5

FREQUENT CLAIMANTS* BY PROVINCE (2006/2007)



Source: HRSDC
* >3 active claims in last five years

MEDIAN VALUE OF RPP'S BY NET WORTH QUINTILE*						
Net Worth Quintile	RRSP only		EPP's only		RRSP and/or EPP	
	%	$	%	$	%	$
All Families	**60**	**25000**	**50**	**65400**	**74**	**65800**
Bottom	19	N/A	23	12100	35	4000
Second	46	6000	39	18400	61	12600
Third	64	15000	58	54900	83	33000
Fourth	81	35000	70	95500	92	100000
Top	87	111100	59	190000	92	250000

*For families with financial assets; Source: Statistics Canada, Survey of Financial Assets 2005

years), but frequent usage was particularly exaggerated in the Atlantic. Clearly, despite high Atlantic unemployment, many EI beneficiaries regain employment in order to claim EI in a subsequent year. Moreover, 40% to 50% of Atlantic claimants are seasonal (being received at the same time as in the previous year). Seasonal EI use indicates that unemployment is not "unexpected," and such frequent use impairs the "insurance" character of the system.[27]

A return to "intensity rules" to discourage repeat use would remedy the current use of EI as a regionally-directed subsidy for seasonal industries and correct its promotion of persistent pockets of unemployment.

On income security for retirees, the erosion of household net worth during the current downturn has further exacerbated the already troubling degree of under-saving for retirement. Current old-age transfers are designed to provide subsistence, and formal pensions or self-saving for retirement (rather than government transfers) are obviously most desirable.

Pension coverage by employer-provided registered pension plans has declined, standing at 23% of private sector employees in 2006, compared with 30% in 1991. Moreover, defined benefit coverage for private sector employees has shrunk from 26% in 1991 to 17% in 2006.[28]

However, voluntary programs have been ineffective in sufficiently buoying retirement savings: RRSP contributions are low (only 31% of eligible tax filers made an RRSP contribution in 2007 and contributions represented only 6% of the room available to filers). Further evidence is that contributions are biased towards individuals in the top 20% of the income distribution. This cross-section has a potential bias since pre-retirement individuals will hold more retirement assets and typically also be within their highest income-earning years. However, the low contribution rates - especially for low income households - flag under-saving.

This points to a possible government mandate to ensure adequate income security during retirement – especially recognizing that a lack of adequate saving will compel government expenditures on transfers. While purely optional programs have not been entirely successful, a mandatory arms-length but government-provided defined contribution program (with either full opt-out or a mandatory RRSP alternative) could meet savings objectives, overcoming myopia and cognitive costs, while not infringing on individual choice if an individual chose to exercise that choice.

Paying the bill

During the present downturn, government budgets have been stretched by procyclical program expenditures, by declining tax revenues and by the demand for "stimulus". Moreover, the recovery will be sluggish and, barring a productivity boom, we should expect a much lower pace of potential growth even following recovery.

Indeed, using a profile drawn from current program expenditures, we do not forecast the federal government will return to fiscal balance over the next five years. Based on their current tax systems and program expenditures, many provincial governments will similarly face structural deficits. Moreover, without any tax increases, growth in program expenditures would need to restrained to 2% after 2011 (compared with a 6-8% trend since the late 1990s) in order to achieve a budgetary balance by 2015.[29] This implies hard choices on spending and taxation ahead: governments cannot run deficits indefinitely and most taxes do involve some deadweight loss.

Those expenditures with high social returns should earn priority. This also places a premium on well-designed social programs that address clearly defined problems, promoting long-run growth while minimizing distortions to well-functioning labour markets. As well, social planning that leverages individual efforts will minimize government expenditures and be more politically sustainable in the longer-term.

The sustainability (both fiscal and political) of social programs also has an "accounting" dimension: Insofar as feasible, "social insurance" programs should be either integrated with our personal income tax system or otherwise insulated from general revenues, and, ideally, be self-financing over an appropriate horizon.

For instance, the delivery of old-age and child benefits through the tax system minimizes administrative costs, and ensures effective targeting of the full suite of transfers. Moreover, benefits delivered through refundable tax credits allow more integrated and incentive-compatible targeting of transfers, and, because of this integration, achieve a degree of insulation from future program cuts.

Employment Insurance and the Canadian Pension Plan are two examples where segregated accounts, along with appropriately mandated but independent boards, have bolstered the sustainability of program finances.

For "social investments", governments would ideally shift to some separation of these expenditures from operational expenditures in the manner that we segregate and amortize capital investments. Similar to infrastructural spending, deficit-constrained governments may defer major expenditures on human capital investment, since the benefits of such expenditures would not be immediate relative to the costs that would be incurred.

On the other hand, if not appropriately designed, such a regime would be a means to hide deficits. Since "human capital" is not a publically-owned asset (like a bridge or building), the ambiguity of accounting for its social returns would pose an additional problem.

Nonetheless, distinguishing between expenditures that are ongoing and those that are expected to yield future returns would better brace education-focused governments and help direct such investments.

"Transform" and roll out?

To sum up, the current recession creates the impetus for a "transformation" in social policy and certain conditions are ripe for such a move. However, the hurdle is in forging a workable consensus – especially in the context of a fractious minority parliament. Nonetheless, better social policy is a critical ingredient to achieving economic growth.

This will require jettisoning ideological baggage that views social programs and economic growth in tension, and instead re-designing social policy to enhance productivity. To this end, policy makers should orient social programs around insurance, investment and inclusion, attending to their "incentives" and "returns".

Don Drummond, SVP & Chief Economist
416-982-2556

Grant Bishop, Economist
416-982-8063

Endnotes

1 Assembly of First Nations. *It's our time: A discussion paper for the council of the federation*. August 5, 2009.

2 Helliwell, J. F. 2005. *Well-being, social capital and public policy: What's new?* NBER Working Paper.

Helliwell, J. F., H. Huang, and R. D. Putnam. 2007. "How's the job? Are trust and social capital neglected workplace investments?" in *Social Capital*. Bartkus, V.O. and Davis, J.H. (eds.).

3 For reviews see:

Riddell, W. C. 2007a. "Investing in human capital: Policy priorities for Canada" in *A Canadian Priorities Agenda: Policy Choices to Improve Economic and Social Well-being*. St-Hilaire, F., C. Ragan, and J. Leonard (eds.). Institute for Research on Public Policy, McGill Queens Univ Press.

Moussaly-Sergieh, K., and F.Vaillancourt. May 14, 2009. *Extra earning power: The financial returns to university education in Canada.* C.D. Howe Institute

4 Knudsen, E. I., J. J. Heckman, J. L. Cameron, and J. P. Shonkoff. 2006. Economic, neurobiological, and behavioral perspectives on building America's future workforce. *Proceedings of the National Academy of Sciences* 103, (27): 10155.

Heckman, J. J. 2006. Skill formation and the economics of investing in disadvantaged children. *Science* 312, (5782): 1900-2.

5 Trefler, D. 2008. Innis lecture: Canadian policies for broad-based prosperity. *Canadian Journal of Economics.* 41, (4): 1156-84.

———. 2004. Looking backwards: How childhood experiences impact a Nation's wealth. *University of Toronto*.

Riddell, W. C. 2007b. The impact of education on economic and social outcomes: An overview of recent advances in economics. *Fulfilling Potential, Creating Success: Perspectives on Human Capital Development*: 55.

6 Baker, M., J. Gruber, and K. Milligan. 2008. Universal child care, maternal labor supply, and family well-being. *Journal of Political Economy* 116, (4): 709-45.

7 Milligan, K. 2004. Who Uses RESPs and Why. UBC Working Paper (http://www.econ.ubc.ca/kevinmil/research/dp0403.pdf)

8 Finnie, R., C. Laporte, and E. Lascelles. 2004. Family background and access to post-secondary education: What happened over the 1990s? *Analytical Studies Research Paper Series.Statistics Canada Catalogue 11F0019 MIE2004226*.

Junor, S., and A. Usher. 2007. *The end of need-based student financial aid in Canada.* Toronto: Educational Policy Institute.

Usher, A. 2004. *Are the poor needy? Are the needy poor? The distribution of student loans and grants by family income quartile in Canada.* Toronto: Educational Policy Institute.

———. 2004. *Who gets what? The distribution of government subsidies for post-secondary education in Canada.* Toronto: Educational Policy Institute.

9 Neill, C. 2007. *Canada's tuition and education tax credits.* Canadian Millenium Scholarship Foundation.

10 Junor and Usher (2007)

11 Drummond, D., E. Beale, K. Kobly, M. Loiselle, and R. Miner. May 20, 2009. *Working together to build a better labour market information system for canada.* Advisory Panel on Labour Market Information.

12 Gilmore, J., and C. Le Petit. 2008. The Canadian immigrant labour market in 2007: Analysis by region of postsecondary education. *Analytical Studies Branch Research Paper Series*. Statistics Canada.

13 Alboim, N., R. Finnie, and R. Meng. 2005. The discounting of immigrants' skills in Canada: Evidence and policy recommendations. *IRPP Choices* 11, (2): 1-26.

14 Warman, C. 2007. Ethnic enclaves and immigrant earnings growth. *Canadian Journal of Economics* 40, (2): 401-22.

15 Hou, F., and G. Picot. 2003. Visible minority neighbourhood enclaves and labour market. *Analytical Studies Branch Research Paper Series*. Statistics Canada.

16 Hou, F. 2009. Immigrants working with co-ethnics: Who are they and how do they fare? *International Migration* 47, (2): 69-100.

17 Oreopoulos, P. 2009. Why do skilled immigrants struggle in the labor market? A field experiment with six thousand resumes. *NBER Working Paper*.

18 Pérusse, D. 2008. Aboriginal people living off-reserve and the labour market: Estimates from the labour force survey, 2007. *Analytical Studies Branch Research Paper Series*. Statistics Canada.

19 Burleton, Derek. June 11, 2009. *Aboriginal People in Canada: growing mutual economic interests offer significant promise for improving the well-being of the aboriginal population.* TD Economics.

20 Richards, J. 2008. *Closing the Aboriginal/non-aboriginal education gaps.* C.D. Howe Institute.

———. 2006. *Aboriginal Policy: Creating Choices.* C.D. Howe Institute.

21 Duclos, J. Y. 2008. "A better income security system for all Canadians" in *A Canadian Priorities Agenda: Policy Choices to Improve Economic and Social Well-being*. St-Hilaire, F., C. Ragan, and J. Leonard (eds.). Institute for Research on Public Policy, McGill Queens Univ Press.

22 Stapleton, J. November 2008. *Income security for working-age adults in canada: Let's consider the model under our nose.* Metcalf Foundation.

23 Baldwin, A., J. Stapleton, and D. Drummond. September 2008. *New asset and income policies to assist low income adults under Ontario's poverty reduction strategy.* TD Economics.

24 Drummond, D., D. Burleton, and G. Manning. June 17, 2003. *Affordable Housing in Canada: In search of a new paradigm.* TD Economics.

Steele, M., and F. Des Rosiers. May 2009. *Building affordable rental housing in unaffordable cities: A Canadian low-income housing tax credit.* C.D. Howe Institute.

25 Oliphant, M., S. Pomeroy, M. Steele, J. Hoy, and J. Stapleton. November 2008. *A housing benefit for Ontario: One housing solution for a poverty reduction strategy.* Daily Bread Foodbank.

26 Bishop, G., and D. Burleton. April 30, 2009. *Is Canada's Employment Insurance Program Adequate?* TD Economics.

27 Charette, J., P. Blackstaffe, and A. Piche. March 31, 2009. *EI monitoring and assessement report 2008.* Canada Employment Insurance Commission (HRSDC).

28 Gougeon, Philippe. May 2009. Shifting pensions. *Perspectives on Labour and Income*. Statistics Canada.

29 Drummond, D., and D. Burleton. June 2, 2009. *TD Economics' Five-year Federal Fiscal Forecast.* TD Economics.