Federal Policy Directions to Enhance Productivity while Reducing Inequality

Written Brief to House of Commons Standing Committee on Finance regarding motion:

"That the Standing Committee on Finance be instructed to undertake a study on income inequality in Canada and that this study include, but not be limited to, (i) a review of Canada's federal and provincial systems of personal income taxation and income supports, (ii) an examination of best practices that reduce income inequality and improve GDP per capita, (iii) the identification of any significant gaps in the federal system of taxation and income support that contribute to income inequality, as well as any significant disincentives to paid work in the formal economy that may exist as part of a "welfare trap", (iv) recommendations on how best to improve the equality of opportunity and prosperity for all Canadians; and that the Committee report its findings to the House within one year of the adoption of this motion."

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Introduction

The Canadian economy delivers opportunity and prosperity to a clear majority of its citizens. But can we maintain this? Can we do better?

There are two key steps to improving general prosperity. One is to increase productivity to improve output. The second is to ensure that gains are widely shared.

Canada's productivity growth has been slow. In terms of output per hour, growth averaged about 4 per cent per year until the early 1970s but for the rest of the 20th century averaged about 1.5 per cent per year. This century it has averaged less than 1 per cent per year.

Moreover, the gains the economy has generated have gone disproportionately to the top of the income distribution. Table 1 below shows that the top 1%, the top 0.1% and the top 0.01% have received after-tax-and-transfer income gains of 77%, 131% and 160% between 1986 and 2010, adjusting for inflation. The comparable gain to the bottom 90% is 19%.

There are no magic bullets that will solve these twin problems. Quite possibly the policies that would make the biggest impact on one problem would worsen the other. Hence I focus on three modest policy directions that I think have some prospect for acceptance across the political spectrum and that I think will at least move towards improving productivity growth and for reducing inequality.

Table 1: Canadian Top End Incomes (After tax/transfer incomes, incl. capital gains, 2012$)		
	2010 average	change since 1986
Top 1%	378K	77%
Top 0.1%	1386K	131%
Top 0.01%	4693K	160%
Bottom 90	27K	19%
90-95	79K	22%
95-99	113K	31%

Corporate Regulation

The first relates to corporate regulation. Dr. Randall Morck, a distinguished Professor in the Business School of the University of Alberta, writes (Morck, 2010), "In practice, the typical big Canadian corporation is arguably less democratic than in the past, and less democratic than its peers in both America and Great Britain. This is because corporate insiders dominate the shareholder meetings of listed Canadian firms to an extent generally not seen in either the United States or the United Kingdom, and because Canadian legislatures, courts, regulators, and exchanges accept and passively perpetuate this." He continues, "a large and growing body of evidence shows Canadian corporations underperforming across the board' and that this is 'no coincidence, for much empirical evidence links shareholder democracy to firm and economy performance."

Bris (2005) found that Canada had more insider trading than any other developed country. (In the United States during his sample period, most commonly share prices jump at the time a takeover bid is officially announced. In Canada, he found it was more common for share prices to jump in advance of the official announcement.) McNally and Smith (2003, 2010) find poor although improving insider trading disclosure on the TSX; Compton, Sandler and Tedds (2009) raise serious issues regarding options backdating in Canada. Tedds, Compton, Morrison, Nichols and Sandler (2011) find shortcomings in disclosure of granted options in Canada.

An environment with weak shareholder democracy and insider power is one which may well, in some instances, lead to weak corporate governance and excessive executive compensation. At the same time, it may hamper the ability of the corporate sector as a whole to raise capital, to provide opportunities for innovative newcomers and to deliver growth.

With respect to policies, I would advocate only limited interventions. But, along with Professor Morck, I believe that the situation would improve with federal government security intervention, which would prevent a race to the bottom by provincial regulators. Changes to federal tax law that disadvantaged dual-share structures (that is shares with different voting powers) would also limit pyramid structures, which enable one shareholder or one family to control many layers of companies that Professor Morck notes that this structure is almost unknown in Britain and the United States but is widespread in Europe, Asia and Central and South America.

Intergenerational Mobility

The currently available evidence (Corak, 2012; Corak and Heisz, 1999; Corak and Piraino, 1999; Corak, Curtis and Phipps, 2011) suggests that Canada has better intergenerational mobility than the United States. This means that in Canada as compared to the United States, a poor father is much more likely to have an affluent son and an affluent father is more likely to have a poor son. (Unfortunately the international comparisons have been almost all done using men rather than women.) In this respect, Canada is comparable to the Scandinavian countries (even though Canada is income distribution is much less equal).

More equal opportunity is desirable in its own right. In addition, by allowing advancement to depend more on merit and less on family position, it has been perhaps the most important force behind the economic success of the modern democracy.

This Canadian success is probably largely attributable to relatively equal access to high quality schooling for most Canadians. I fear that provincial budget crunches may jeopardize this.

The scope for federal policy is limited here, particularly as federal policies have focused on post secondary education while it is probably early age education, elementary and secondary education which are most important in this regard. Pre-natal health (Currie, 2012) is also important for intergenerational mobility, although again health is largely a provincial responsibility. But the importance of education and health policies for national prosperity is an important backdrop to such discussions as equalization.

Taxation

I am not sure we have the evidentiary base to be sure that an increase in marginal tax rates at the top will raise tax revenue. A more promising approach is to eliminate those tax expenditures that tend to benefit the affluent. I strongly support the removal of the Labour Sponsored Venture Capital Fund credit in the recent budget, as well as the correction of the provision which allowed the dividend tax credit to exceed the corporate tax paid in the case of small business. Among others, I believe the Employee Stock Option Deduction (see Martin, 2011; Sandler, 2001; Tedds, Sandler and Compton, 2012) for various views of the disadvantages of option compensation and hence arguments against their tax preference) and the Registered Education Savings Plan (see Milligan, 2005) should be targets for scrutiny. More broadly, while I do not see a strong case for the Children's Art Tax Credit or the Children's Fitness Credit, if they are to exist, I believe it is even harder to make the case for nonrefundability. As I have written (Veall, 2012, p. 1263), "In effect, these subsidize the participation in the arts and sports activities for children in all families except those too poor to be subject to personal income tax, probably the only families for which the subsidy might make an appreciable difference."

Conclusion

My policy recommendations are modest. I favour moving to federal securities regulation and to disadvantage dual class shares as ways of improving shareholder democracy and reducing the power of insiders. This potentially will have a beneficial effect on productivity (improving the ability of firms to raise capital and allowing easier entry by innovating newcomers) as well as curbing any executive compensation that is more attributable to cronyism than to performance.

Second, I favour the federal government doing what it can, perhaps through the new Equalization formula, to ensure that provinces continue to deliver relative high quality education across the socioeconomic spectrum in order to promote intergenerational mobility. Not only do poor children deserve as close to an equal a chance as is possible, but the failure to provide such opportunities means that some of the best and the brightest will not be able to contribute to national prosperity.

Third, I favour the elimination of those tax expenditures that tend to be used disproportionately by the affluent but have not had proven success in meeting their objectives. I applaud the Budget's removal of the Labour Sponsored Venture Capital Corporation tax credit and the overpayment of the dividend tax credit to small business. I suggest other tax expenditures be scrutinized.

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