Brief Submitted to the House of Commons Standing Committee on Finance

Topic: Income Inequality in Canada
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1.0 Introduction

Across the developed world, there is a growing consensus that evaluations of national economic performance should not rely exclusively on measures of overall growth in Gross Domestic Product (GDP), but should also take into account changes in a country's income distribution.[1] In many affluent countries, including Canada, high earners have enjoyed a large share of overall income gains in recent years, while real income growth throughout most of the rest of the income distribution has been considerably slower.[2]

The committee has been asked to undertake a study of income inequality in Canada, and to consider best practices that can reduce income inequality in this country. This brief examines a number of different policy options that can help achieve this objective.

Canada is not alone in recognizing and seeking to address this issue. Inequality has grown considerably in most economically developed countries over recent decades, and governments and governance advisory bodies around the world have considered the question of what if any policy response is desirable. Specifically, the *Organization for Economic Cooperation and Development* (OECD), which provides policy advice to economically advanced countries, has performed extensive research on these issues relying on economic theory as well as the experiences of member countries. The OECD's research and advice in this area is consistently thorough and valuable, and this brief relies in large part on that body of work.

We can distinguish between two different types of policy responses designed to address income inequality. First, there are policies that would likely reduce income inequality, but would bring unwanted tradeoffs in the form of reduced economic growth. Secondly, there are policy options that would be likely to reduce income inequality but would create what the OECD describes as a "double dividend" in that they would also be likely to increase economic growth.[3]

The author of this brief suggests that the committee should focus on the second of these two groups of policy options. Robust economic growth is essential for continued job creation, poverty reduction and government revenue generation. Policies that aim to reduce inequality at the cost of lost economic growth are therefore ill advised. Instead, the committee should focus on policy responses that are likely to be at least neutral and hopefully beneficial to economic growth, while helping to reduce inequality by promoting strong income growth at the bottom and middle of the income distribution.

While this brief will present several policy options that are likely to help boost income growth at the bottom and middle of the income distribution, the committee should be cognizant of the fact that there are powerful economic and demographic forces that are likely to be pushing in the direction of continued income inequality growth in the years and decades ahead.

First, Canada's population is aging. Generally speaking, there is greater income inequality among older workers than younger workers.[4] The wages and salaries of highly educated, highly skilled workers tend to increase faster over time than the wages and salaries of less skilled workers, leading to greater income disparities towards the end of careers than existed at the beginning. For this reason, the American economist Tyler Cowen observes that owing to an aging population "our measured income inequality will increase pretty much by demographic fiat."[5] This, of course, does not mean that governments are powerless to mitigate the growth of income inequality, but we must recognize that there are important demographic forces pushing in the direction of greater income inequality. Further, these facts may lead some to conclude that some portion of the measured increase in income inequality is more-or-less benign, as it is partly a function of a simple demographic shift, and the movement of more people into more unequal age cohorts.

Secondly, there are global economic market forces related to technological change and globalization that are continuously driving up demand for highly skilled labour.[6] This rising demand for highly skilled labour and individuals with unusual talents is likely to continue to drive significant income gains for individuals at the very top of the income distribution in the coming years and decades. Even if the federal government is able to develop effective policy responses that help boost the incomes of families in other parts of the distribution, these rapid income gains at the top may contribute to continued increases in income inequality. It is important to recognize the technological and economic forces driving income gains at the top, and to recognize that these gains are not necessarily coming at the expense of other workers. The government's objective should be to identify policy options that can contribute to robust income gains for families in other parts of the income distribution as well.

There are economic and demographic forces that are likely to push in the direction of increased income inequality in the years ahead. However, there are several options for policy reform that can help increase the after-tax incomes of low-, moderate- and middle-income families. The government should study and pursue these types of reform, while recognizing that continued income gains at the top are likely, that these may continue to drive inequality growth, and that these income gains are not in and of themselves harmful, or necessarily coming at the expense of other workers.

The second section of this brief discusses the "wrong" way to address inequality, which is the introduction of growth-restricting increases on personal and corporate tax rates paid by high earners. The third section examines the "right" way to support income gains throughout the income distribution through growth-friendly policy reforms. The fourth section concludes.

2.0 The Wrong Way To Address Inequality: Higher Tax Rates

Proponents of much higher personal income tax rates, higher corporate tax rates and higher capital gains tax rates often point to the growth in income inequality as a reason to increase these taxes. Their argument holds that since such a large proportion of income gains over the past thirty years have been captured by individuals at the very top of the income distribution, we can address inequality by increasing the taxes that these individuals pay. This approach, theoretically, can address the inequality issue at both ends of the spectrum by reducing the after-tax income of wealthy individuals while raising revenue that can then be redistributed through direct transfers, raising the after-tax-and-transfer income of families closer to the bottom of the income distribution.

However, this at some point becomes a self-defeating approach. The reason is that many of the taxes that would, in theory, most accurately target high-income individuals are among the most distortionary and economically harmful taxes. Personal and corporate income taxes, for example, which are among the most progressive taxes that exist in developed countries are among the very most economically harmful taxes because of their negative effects on labour use, productivity and capital accumulation. [7] For this reason, the OECD advises countries to recognize that raising these types of highly distortive taxes in an effort to reduce income inequality may have negative trade-offs in terms of lost economic growth.[8]

A second problem with this approach is that it would not necessarily raise very much new revenue. A recent paper co-authored by Alan Carter and Stephen Matthews of the OECD's International Tax Dialogue Secretariat and Centre for Tax Policy and Administration observed that OECD countries are likely to be disappointed by the revenue gains from higher marginal personal income tax rates on high earners. They write that owing to "effects on work intensity, career decisions, tax avoidance and other behavioural responses" simply raising marginal personal income tax rates will "not necessarily bring in much additional revenue."[9]

These facts suggest that for countries like Canada, increasing the rates on the most progressive taxes is a flawed strategy for addressing income inequality. This approach risks significant losses to economic growth (which harms families throughout the income distribution) and is likely to raise disappointing amounts of revenue. Fortunately, there are other policy responses available that can help promote strong income growth in the bottom and middle of the income distribution that do not come with tradeoffs in terms of growth. In fact, there are a number of policy options that can help address income inequality while *contributing* to economic growth. We turn to examine some of these policy options in the following section.

3.0 The Right Ways To Address Inequality: Policy Strategies That Encourage Economic Growth

The OECD divides up possible policy responses designed to address income inequality into two broad categories. The first category consists of policies that may reduce income inequality, but are likely to bring negative tradeoffs in the form of lost economic growth.[10] The second category consists of policies that are likely to reduce income inequality but which are also likely to *contribute* to economic growth. They describe this category as policies that produce a "double dividend" in that they boost GDP per capita while reducing income inequality.[11] Any strategy of the federal government aimed at addressing income inequality in Canada should focus on policy options that belong to this second category. This section presents several examples of this type of policy reform that are particularly promising in the Canadian context and worthy of study by the committee.

3.1 Pro-Growth Tax Reform

The preceding section noted that while raising income tax rates and corporate tax rates on high earners may reduce inequality, there would likely be an unwelcome trade-off in the form of slower economic growth, which harms families throughout the entire income distribution. However, there are steps that the government can take to reform the tax codes in ways that can reduce after-tax income inequality without negative effects on growth.

The OECD notes that one of the most growth-friendly ways to increase government revenues is to close loopholes in tax codes, many of which disproportionately benefit high-income earners. They observe that because "many tax breaks favour high income individuals disproportionately," the case for reviewing the effectiveness of these loopholes "is clearly compelling."[12] The government should undertake a comprehensive review of existing loopholes and deductions with the objectives of simplifying the tax code and eliminating distortive loopholes and deductions that benefit high-earners disproportionately. Tax reform along these lines that resulted in a simplified tax code could also bring the added benefits of reduced administrative costs and higher rates of tax compliance.

Ideally, any additional revenue that resulted from this type of review would be returned to taxpayers to prevent negative effects on growth from a higher overall tax burden. For example, new revenue obtained by closing loopholes and eliminating deductions that benefit high earners could be used to provide a growth-promoting reduction in income tax rates. If the rate-cuts were provided "across-the-board," or focused primarily on middle-income families, this reform could make the tax code more efficient and growth-friendly while also reducing after-tax income inequality.

A second option would be to use the revenue obtained by closing loopholes that benefit high-income individuals to expand pro-employment tax deductions that benefit lower-income families. Generally speaking, a simplified tax code with transparent rates and few deductions is preferable to a more complicated tax code. However, tax deductions that promote employment and increase the after-tax incomes of low- and middle-income families are deserving of continued support because of their positive effects in terms of employment, economic growth and income inequality. The Working Income Tax Benefit (WITB), which provides tax relief for working low-income individuals and families is one good example. The WITB is still relatively new, but the similar Earned Income Tax Credit (EITC) in the United States has been studied extensively, and shown to have positive effects on employment and after-tax income for low-income families.[13] The OECD observes that across multiple jurisdictions similar policies, categorized as in-work tax credits, generally reduce income inequality.[14]

Tax deductions and similar benefits that promote employment for low-income families are useful policy tools that can reduce poverty, strengthen labour market performance and reduce after-tax income inequality. The committee should study the effects of the WITB in Canada to date and consider options for expanding the benefit to include more families and to increase the maximum benefits available to working low-income families.

Raising tax rates on high earners is the wrong way to combat inequality because doing so may have significant negative effects on economic performance to the detriment of families throughout the income distribution. There are, however, much more growth-friendly approaches to tax reform that can help address income inequality without negative effects on growth. In fact, some reform options would be likely to decrease income inequality while strengthening economic growth.

3.2 Promote Economic Integration for New Canadians

Canada's prosperity in the coming decades will largely depend on our ability to attract skilled immigrants and to capitalize on their talents and training.

Unfortunately, many skilled immigrants who arrive in Canada face regulatory barriers that prevent them from working in the professions for which they are trained. In order to promote social cohesion, maximize economic growth and enable new Canadians to fully participate in the economic life of our country, it is essential to remove unfair barriers to professional practice for well-qualified skilled immigrants.[15] Creating transparent systems of recognizing foreign qualifications can help reduce inequality by reducing the labour market performance gap between immigrants and non-immigrants, while simultaneously boosting economic growth by increasing immigrants' contribution to national income.[16]

The federal government should lead a coordinated effort to address these issues, working cooperatively with provincial governments. In August 2012, the Frontier Centre for Public Policy published an e-book on this subject authored by Professor Bryan Schwartz, a Professor of Law at the University of Manitoba. Schwartz recommends a number of specific actions that the federal government could take to help remove barriers to professional practice and improve labour market performance for skilled new Canadians. These actions are:

- Amend the Federal Competition Act to clarify that unnecessary barriers to entry into professions are not allowed.
- Restructure Canada's immigration laws and practices, particularly by refining the point system for evaluating the strength of applications for immigration. A new formula should include measures of the extent to which an applicant's home country credentials would be recognized upon the applicant's arrival in Canada.
- Convene a First Ministers meeting to develop a jointly coordinated action plan to address these issues.[17]

Generally speaking, the Federal government should develop a strategy to work with the provinces to remove barriers to professional practice for immigrants to Canada. These are a few examples of specific actions that should be considered. Working to remove these barriers can improve the labour market performance of Canadian immigrants, thereby helping to reduce income inequality while simultaneously boosting economic growth.

In connection with the proposed effort to promote economic integration for new Canadians, the federal government should also lead a broader national effort to remove unnecessary barriers to access to skilled trades, which effect immigrants and native-born Canadians alike. There is a significant body of evidence suggesting that in some cases, licensing requirements and other barriers to apprenticeships and entry-level participation in skilled trades advance few if any legitimate policy interests. Instead, economists and political scientists suggest many such barriers exist primarily to protect incumbent service providers from competition.[18] By leading the provinces in a cooperative, coordinated effort to remove unnecessary restrictions on occupational freedom, the federal government can help provide opportunities for currently low- and moderate-income individuals to develop marketable skills.

3.3 *Improve Access To Educational Opportunities for Low-Income Families*

The OECD notes that policy initiatives that increase a country's human capital are likely to boost national income overall and are also likely to reduce labour income inequality.[19] Policies that improve access to high-quality educational opportunities for individuals from low-income families are especially likely to promote economic mobility and reduce income inequality.

Education policy generally falls under provincial jurisdiction. However, the federal government maintains a significant presence in this policy space, and there is room to reform federal policy in ways that can boost economic growth and promote equality of economic opportunity over the medium-term.

Specifically, the federal government's approach to early childhood education (ECE) is long overdue for a rethinking. Reforms in this area hold the potential to promote equality of opportunity for low-income families and to reduce income inequality over time.

A large body of evidence exists showing that, for children from low-income families, access to high quality early childhood education can improve educational and economic outcomes over the course of an entire lifetime.[20] Some studies also show (much smaller) positive medium-term effects for children from middle-income families, but the evidence is ambiguous.

In fact, the evidence suggests that targeted investments designed to ensure access to high quality early learning for lower-income families can generate long-term benefits that significantly outweigh the upfront costs.

Unfortunately, federal policy in this area is not sufficiently focused on the objective of providing assistance to the low-and moderate-income families who would benefit most from assistance. A centerpiece of current federal policy is the Universal Child Care Benefit (UCCB), which is a cash benefit that is paid out monthly to all families with a young child. This universal subsidy flows to all families, rich and poor alike.

One straightforward improvement to federal policy design in this area would be to simply means-test the UCCB by ending benefit payments to high-income families where financial assistance is least needed. This is the approach that has been taken in by the government of the United Kingdom, which has recently announced plans to means-test its own child benefit (which in the UK lasts until children reach the age of 18).[21] Of course, policy design is important, and benefits must be phased out gradually to prevent the creation of work disincentives for families with moderate incomes.

The savings from means-testing the UCCB could be applied to making the benefit more generous for lower-income families. Alternatively, the money could be transferred to the provinces, enabling them to use the money to strengthen the means-tested childcare subsidy programs that exist in most jurisdictions, which help promote access for low- and moderate-income families.

By means-testing the UCCB and applying the savings to increasing assistance for lower-income families, the federal government can help mitigate inequality in both the short-and long-run while contributing to long-term economic growth.

The federal government is also an active participant in higher education policy across Canada. Throughout the country, there exists a significant post-secondary participation gap between young adults from high- and low-income families.[22] The Federal government should work with the provinces to strengthen loan and grant programs that are targeted at low- and moderate-income households in an effort to reduce this gap. As is the case in the childcare sector, an optimally effective federal role in higher education would eschew the distribution of popular universal or nearly universal tuition subsidies that have been considered in the recent past, in favour of a targeted approach that directs assistance where it is most needed.

The OECD identifies "improving the quality and reach" of education as one of the most effective policy strategies to produce the "double dividend" of stronger economic growth and reduced income inequality.[23] The committee should consider strategies that the Federal government can use to leverage its role in these primarily provincial policy areas to help improve access to high quality learning opportunities for low- and moderate-income families.

4.0 Conclusion

In recent decades, income growth for families at the bottom and middle of the income distribution has been disappointing. Developing policy strategies to strengthen after-tax income gains throughout the income distribution should be a top economic priority for the federal government in the years ahead.

While the government should prioritize strengthening income gains and ensuring equality of opportunity for all Canadian families, it should not pursue policy approaches designed to reduce income inequality that are likely to have negative effects on economic growth. Strong economic growth is essential to Canada's efforts to improve labour market performance, reduce poverty and ensure government revenue generation that is adequate to provide high-quality public services. For this reason, the government should resist calls to reduce income inequality through economically harmful increases to personal and corporate income tax rates.

Instead, the government should study and pursue policy reforms that are likely to strengthen income gains at the bottom and middle of the income distribution while also contributing to overall economic growth. Fortunately, many such policy options exist. By proposing policy strategies that promote rather than hinder growth, the committee can promote economic opportunity for all Canadians while contributing to our country's prosperity in the years and decades to come.

5.0 References

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