November 24, 2014

THE CASE FOR LEANING AGAINST INCOME INEQUALITY IN CANADA

There is growing concern that rising income inequality in advanced economies is posing a threat to economic growth and long-term prosperity. The increase in inequality is being fuelled by a myriad of factors, but particularly key forces are: globalization, technological change, and a resulting fierce competition for talent that has accompanied changing social mores towards compensation.

Economics has traditionally considered income differences to be an incentive for investment and growth, as well as the by-product of the varying skills across workers. However, there is now much more focus on how inequality can act as an obstacle to economic success. Rising inequality can hinder investment in human capital and curtail productivity. It can also reduce social mobility, which can create a negative cycle by further reinforcing and entrenching the upward trend in inequality. The ultimate result is slower economic growth because individuals fail to reach their full potential. Worse still, slow economic growth environments can further foster rising inequality by reducing public support for redistributive policies due to greater competition for the limited income gains being provided by the economy and due to reduced government transfers and program spending reflecting weaker tax revenues.

Canada's experience on the income inequality front is not as black and white as often portrayed. The level of inequality is much lower than in the United States and the increase in inequality has been less pronounced. Importantly, Canada has been far more effective than the U.S. at sharing income between the owners of capital and providers of labour. Whereas rising productivity is traditionally thought to increase the income pie that is then split between capital and labour, the U.S. experience shows the vast majority of the gains from higher productivity going to capital or the very wealthy over the last few decades. In Canada, the historical evidence reveals that rising income has been more evenly split between capital and labour. Canada also has more modest inequality in market income (i.e. less variation in compensation) than Stateside. Relative to the United States, there has been greater effort by public policy in Canada to lean against rising inequality. A key exception was the mid-to-late 1990s, when governments cut transfers to individuals in an effort to eliminate fiscal deficits. Governments then reduced taxes and enacted policies that favoured high-income earners when fiscal surpluses reemerged. This period stands out as it allowed a rapid increase in inequality and demonstrates what happens when policymakers fail to take inequality considerations into their decision making.

While Canada's track record is better than the United States, Canada has experienced a significant rise in inequality over the past several decades. Moreover, a number of trends suggest that income inequality may rise higher, and social mobility could decline, in the years ahead. As a small, trade-oriented economy, Canada is deeply affected by the international forces of globalization, technological change, and competition for talent. Many middle-income and middle-skill jobs have been outsourced or replaced by technology. The fact that Canada has not seen more hollowing out of the middle class, like the experience in the U.S., is primarily due to the commodity and housing boom. Excluding these and related sectors, Canada's middle skill jobs have been under considerable pressure. And, commodity and real estate booms do not last forever. A particular challenge for Canada is the fact that its major trading

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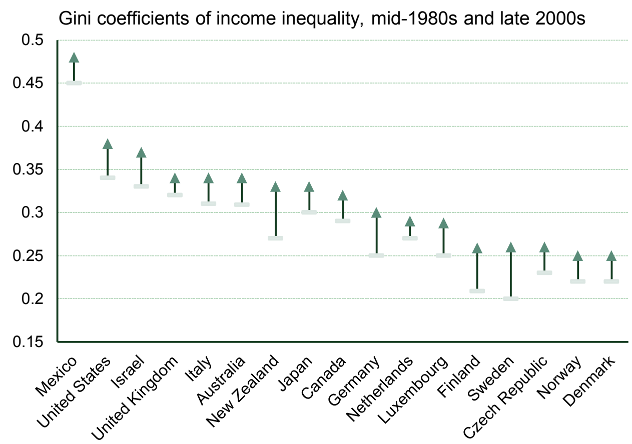
CHART 1: INTERNATIONAL INCOME INEQUALITY



Source: OECD Database on Household Income Distribution and Poverty.

partner and competitor for talent, the United States, allows much higher income inequality. America is willing to pay their low income earners less and their high income earners more than in Canada. The combination of stronger productivity growth and lower compensation in the United States has led to a dramatic drop in U.S. unit labour costs relative to those in Canada. And, the outlook for continued modest economic growth could create pressures fostering greater income inequality in both Canada and the United States.

Canada stands at a cross roads as it is being buffeted by these pressures that could raise income inequality and reduce social mobility. If Canada is to retain its economic and social model, policymakers are likely going to have to lean more against rising inequality. The good news is that there is scope to do so. Governments have limited direct influence on market income, but they can have a strong indirect influence on market income by helping to remove barriers to those lower on the income scale and by boosting the skills of current and future workers. Moreover, there are opportunities to make the tax and transfer system more progressive and redistributive. Although Canadians take pride in the country's more equitable outcomes, Canada does less income redistribution than many think. Canada's ranking on income equality falls from 9th place in the OECD on the basis of market income to 19th place on the basis of after-tax and transfer income. The good news is that policies aimed at reducing income inequality need not dampen economic growth. Indeed, a 2014 report from the IMF argued that equality enhancing actions can improve economic performance in the long run. The main goals for Canada must be to find ways to enhance productivity, thereby boosting the income pie to be split between capital and labour, while also putting in place policies that encourage just income outcomes and facilitate social mobility.

Global forces pushing towards a less fair world

There is no real rival to the capitalist economic model, as it has demonstrated that it best allocates scarce resources and provides the greatest opportunity for economic growth. There is, however, an on-going debate about whether it inherently creates a tendency towards higher inequality. On the one hand, there are authors, like Thomas Piketty, who have highlighted historical evidence that over time the growth rate in the return on capital may be greater than the growth rate of income in the economy, thereby leading to higher inequality over time. This perspective contrasts with other economic literature which emphasizes that market-based economies experience stronger long-run growth that creates income and lifts the standard of living of its workers.

The reality is that the capitalist economic system is very like Winston Churchill's quote that "democracy is the worst form of government, except all of the others that have been tried." In other words, the capitalist economic model generates the best outcomes relative to other economic models, but some of the outcomes from the market-based system may not be economically or socially optimal.

While economic theory and the implications for the capitalist system can be debated, the empirical evidence does show that inequality has increased significantly across much of the industrialized world. OECD data show that income inequality in the advanced world has climbed over the last several decades, rising by more than 10% since the mid-80s, and the increase has been broadly-based across member countries (see Chart 1). A key common theme of these nations has been a rising share of income going to high income earners (see Chart 2). The income of the richest 10% of the population has increased to close to nine times that of the poorest 10%, up from seven times roughly 25 years ago. Naturally, there has been variance in the experience of individual countries. Canada traditionally compares itself to developments in the U.S., and income inequality in America is higher than in Canada and has increased far more. America has the second highest level of inequality in the OECD (second only to Mexico which is not an advanced economy) and America has the greatest share of income going to the top 1% at 20% of total income – the highest share since the roaring 1920s.

Technological change and globalization have fuelled higher inequality

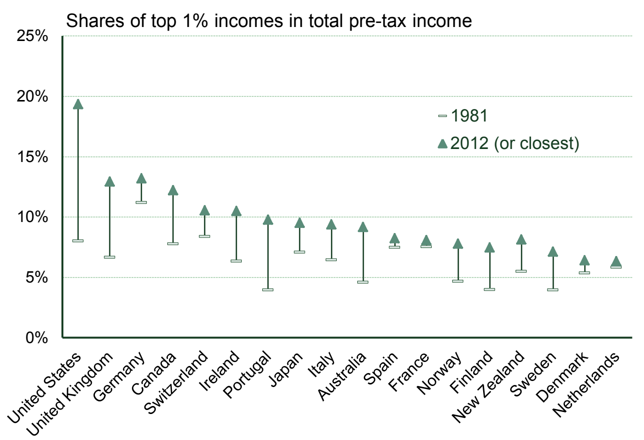
There is a broad consensus that many factors have contributed to the rise of income inequality, but the most powerful structural forces have been technological change and globalization.

Technological advancements have created a world of new possibilities in products and services. However, in the process, they have also reduced the cost of capital relative to labour, with the result that investments in machinery and equipment have either replaced many middle-income, middle-skill workers, or deeply eroded their wage bargaining power. The opposite has been true of high-skill workers, as advancements have created a substantial premium for the talent that can unlock the full potential of new technology. The war for talent is particularly pronounced at the very top end of the skill and experience curve.

Simultaneously, the IT revolution has helped fuel the trend towards globalization by making trade in a broader range of products and services possible by facilitating communication and coordination on a global basis. Businesses (and supply chains) can now operate and coordinate activities anywhere in the world almost seamlessly. As a result, the production of goods and services has been transferred to lower labour cost regions. While this has helped reduce global income inequality by raising employment and wages in the developing nations, the trend has increased inequality within advanced economies by reducing demand for low and middle skill jobs at the same time as putting a premium on high skill workers.

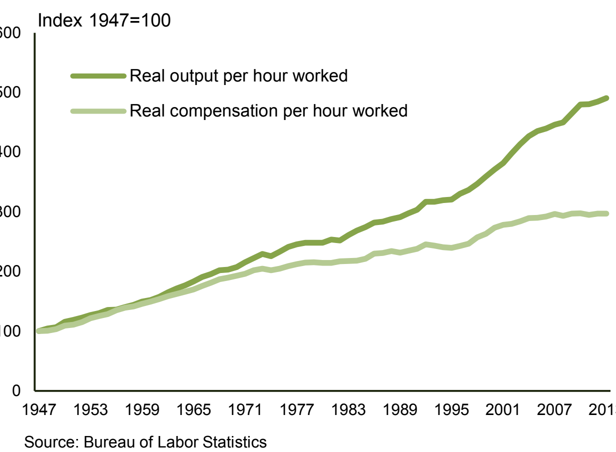
Traditionally, economists have tended to focus on productivity growth as a panacea for rising inequality. The thesis is that a growing income pie will be shared across labour and capital, making everyone better off. However, the interaction of globalization and technological change raises the question of whether or not that idea still holds true today. The reality is that product and process innovations today have very different implications than those of the past.

CHART 2: INTERNATIONAL TOP INCOME SHARES



Source: The World Top Incomes Database.

CHART 3: U.S. LABOUR PRODUCTIVITY & COMPENSATION



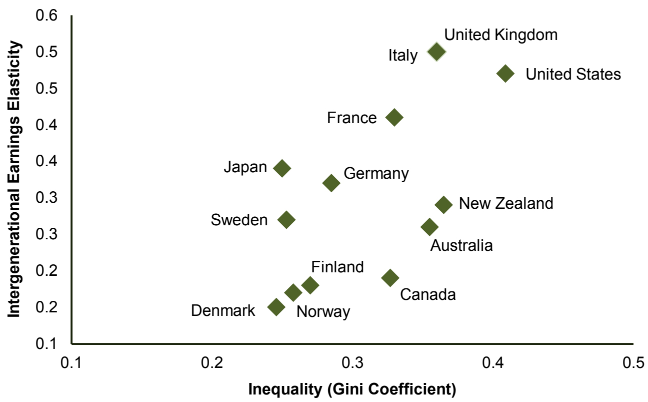
Source: Bureau of Labor Statistics

In years past, innovations required both research and development and then the production of the resulting products from that innovation, which would mean firms have to hire workers locally to build, market and sell the goods or services. Now consider a firm today using advanced technologies. R&D costs could be significant and demand for high skill workers to do the R&D could be strong. However, once the application or product is designed, production can take place anywhere in the world, at the lowest cost. And, the technology often requires less capital and labour than in the past. For example, building the next great computer app requires much less equipment and labour than launching a new product in the traditional manufacturing of the past.

The resulting demand for high skill workers lifts their wage bargaining power, while lowering demand for other workers, depressing their compensation. Thus, innovation may not benefit domestic economies as much today as in the past. The gains are shared more broadly around the world.

In the United States, one can see that the relationship between labour productivity and compensation has broken down since the mid-1970s. While U.S. labour productivity (output per hour worked) has increased significantly, real (after-inflation) compensation per hour worked has not kept pace (Chart 3).

CHART 4: THE GREAT GATSBY CURVE



Source: World Bank, Corak (2012) .

The forces noted above are very impactful in boosting income inequality, but they are not alone. Social changes, like educational assortative mating (i.e. the tendency for high-income earners to marry other potential high-income earners) and the increase in single-parent households have also tended to boost household inequality. Policy changes have also played a significant role. In other words, there have been a host of economic, political and social factors leading to a less equitable world.

Rising inequality a threat to economic growth

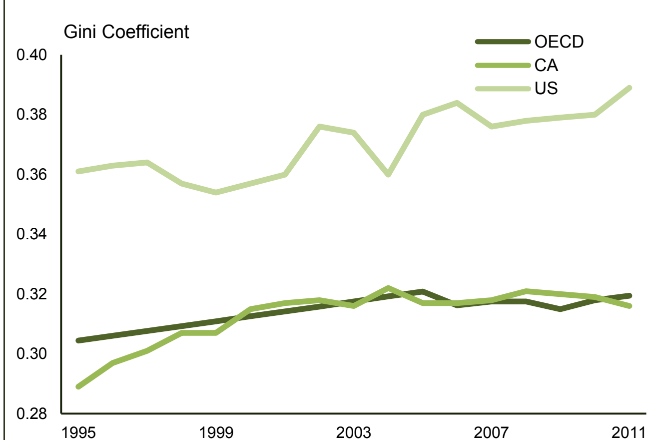
The rising trend in income inequality has raised concerns that it may be harmful to economic growth and prosperity. Economics has traditionally viewed a reasonable level of income inequality as a positive force for creating an incentive to work, save and invest. However, there is an increasing consensus that beyond a certain point, higher inequality can undermine the foundations of market economies. A pronounced degree of inequality can impede skills development for the disadvantaged and prevent individuals from achieving their potential. It can smother innovation and risk taking.

Fundamentally, high levels of inequality can lead to a misallocation of resources, with considerable economic consequences. A number of studies have been done to assess this relationship. Research done by the OECD investigated how rising income inequality statistically impacts growth in GDP per capita (a common metric for changes in a country's the standard of living)[1]. The analysis shows that a 1% increase in inequality lowers GDP growth by 0.6% to 1.1%. They found that the impact did not matter if the inequality came from the rich becoming richer or the poor not keeping pace on income growth. One critical point with regards to this relationship between inequality and economic growth is that the income measure used is after-taxes and transfers – in other words, the income that people actually live on. The suggestion being that inequality can be addressed either through more equal market income (i.e. compensation) or addressed through income redistribution. As we will see in the policy section, however, there are limitations to simply addressing inequality through redistribution.

A key challenge is that a slow economic growth environment can itself be a catalyst towards higher income inequality. First, individuals are likely to be more supportive of redistributive policies to reduce inequality when times are good rather than bad. Asking individuals to share some of their rising income is entirely different than asking individuals to be made worse off to make someone else better off. Second, and related, there is a greater incentive for wealthy individuals to attempt to retain their current and past gains when income is rising slowly in a modest economic growth environment. If these actions become institutionalized, it can impede social mobility, making inequality more persistent and more corrosive.

A lack of social mobility is very damaging because it inherently implies the creation of a permanent misalignment of resources in the economy and the lost opportunity for individuals to fully unlock their potential. The Gatsby curve by Miles Corak (Chart 4) shows the positive correlation between inequality and intergenerational social mobility across countries. It is clear that countries with high income inequality tend to also have high levels of intergenerational earnings elasticity, which means the children of the rich tend

CHART 5: INTERNATIONAL INCOME INEQUALITY



Source: OECD Income Distribution Database.

to end up rich as well while children of the poor tend not to rise up the income distribution.

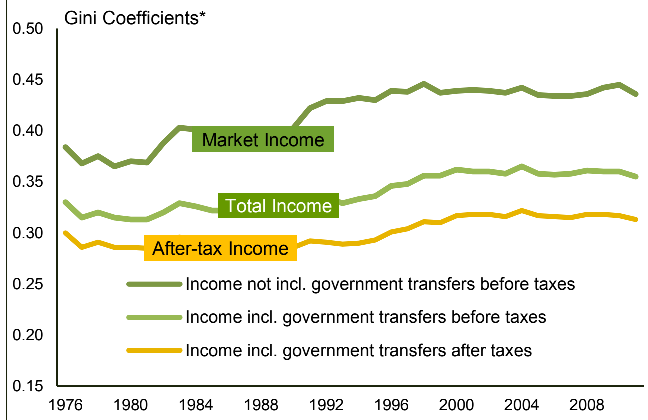
Canada's inequality and social mobility track record

While the global picture has clearly shown a trend towards rising inequality over time, Canada's story is much more nuanced. Comparatively, Canada is in the middle of the pack of OECD nations with regards to income inequality. However, relative to the United States, Canadian inequality is much lower and the increase over time has been less steep (Chart 5). Canada also has a relatively favourable performance on social mobility, as demonstrated by the below average intergenerational earnings elasticity (Chart 4).

On a market income basis (compensation plus capital income but not including government transfers), Canadian income inequality as measured by the benchmark Gini coefficient has increased over time. It was on a gradual rising trend in the 1980s, but then jumped higher in the 1990s. This correlated with the terrible 1990-92 recession and the subsequent jobless recovery that deeply constrained wage and salary growth. Since 2000, however, income inequality has been relatively flat (see Chart 6). This has reflected market income growth across the income spectrum (see Chart 7). Low-income earners have benefited from increases in minimum wage rates. Middle-income earners have had the slowest income growth, but their performance has been better than their U.S. counterparts. In America, there has truly been a hollowing-out of middle skill jobs. The impact of globalization and technological change on Canadian middle skill jobs has been more muted due to the strength in the commodity sector and the construction/real estate sector, both of which employ many middle-income workers. Nevertheless, the number of jobs in non-commodity tradable production industry (i.e. traditional manufacturing) has suffered badly(Chart 8).

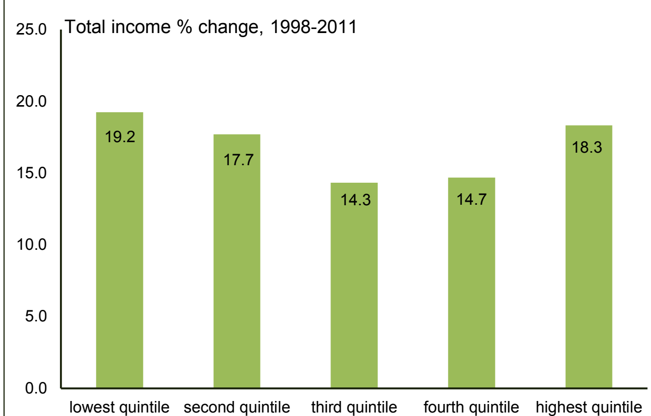
Canada's tax and transfer system plays an important and effective role in reducing inequality. The Gini coefficient after including transfers and applying taxes is roughly 30% lower than the market income Gini (Chart 6). The trend in income inequality over time, however, is broadly the same. Over the 1990s, inequality as measured by the after-taxes and transfers Gini coefficient rose significantly. In part, this was due to both the federal and provincial governments' efforts to fight excessive fiscal deficits. Cuts in transfers from one level of government to the next ultimately fed through to less transfers to individuals (Chart 9). In effect, when governments stopped leaning against income inequality, the

CHART 6: CANADIAN INCOME INEQUALITY MEASURES ADJUSTED FOR HOUSEHOLD SIZE



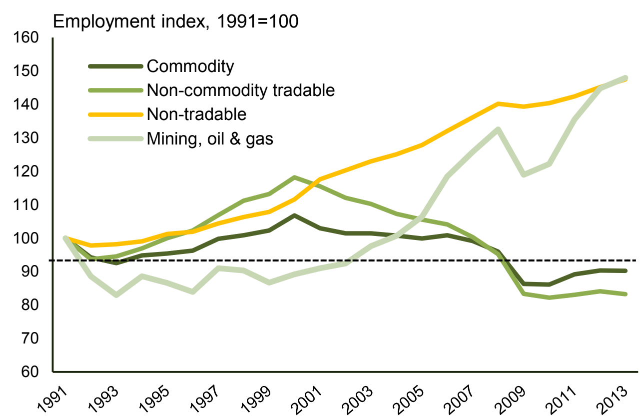
*Higher = less equality; Source: Statistics Canada

CHART 7: HOUSEHOLD TOTAL INCOME GROWTH IN CANADA, 1998-2011



Source: Statistics Canada

CHART 8: CANADIAN EMPLOYMENT BY SECTOR



Source: Statistics Canada

Gini coefficient rose sharply. What is particularly notable is that as fiscal balances were restored and governments put their surpluses to work, income inequality did not decline. Part of the reason is that transfers only stabilized and many policies put in place when surpluses occurred were more beneficial to higher income earners.

While market income and after-tax and transfer income inequality has been relatively flat since 2000, Canada has experienced a rising share of income going to the highest income earners – the top 1% and 0.1% – over time. The share of income of the 1% has climbed from roughly 7.5% of total income in the early 1980s to close to 14% at its peak in 2007. The share of income of the top 0.1% has jumped from around 2.5% to 5% over that time frame (Chart 10). These shares have since fallen and have not recovered to their prior peaks and the trends in Canada have been significantly less pronounced than in the US. Indeed, it is notable that the share of income held by the top 0.1% in the US is identical to the share of income held by the top 1% in Canada.

The increase in the top income shares over time do not materially increase the Gini coefficient for the simple reason that there are only a modest number of individuals in the very top income category. The impact of more income going to the top of the income ladder has also been softened by income growth in the other income quintiles. Nevertheless, the impact of the war for talent and shifting social acceptance to higher compensation at the top end of the income distribution is evident in Canada. It is also worth noting that the data could be under reporting the top income shares due to tax provisions that allow affluent individuals to receive a significant portion of their income indirectly through private corporations. Recent research by Michael Wolfson, Mike Veall, and Neil Brooks suggests that accounting for this income could raise the top 1% income share by as much as 3.3 percentage points, lifting it to just below 14%.

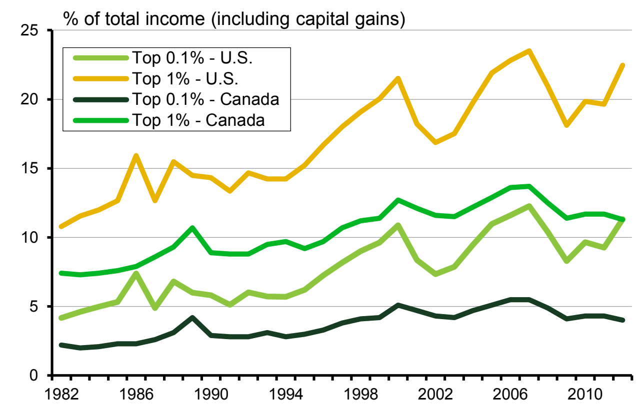
Canadian workers benefit from rising productivity…

The bottom line is that Canada remains a more equitable and socially mobile country than many others, particularly the United States, but it has not been immune from the overall trend towards higher income inequality. Moreover, Canada has seen a more fair division of the split of income between capital and labour. While Chart 3 shows that U.S. workers have not benefited from rising productivity, the story in Canada is very different (Chart 11). After the end of the Second World War and until the mid-70s, Canadian real (after-inflation) compensation per hour worked rose in

CHART 9: GOVERNMENT TRANSFERS AS A SHARE OF CANADIAN HOUSEHOLD INCOME

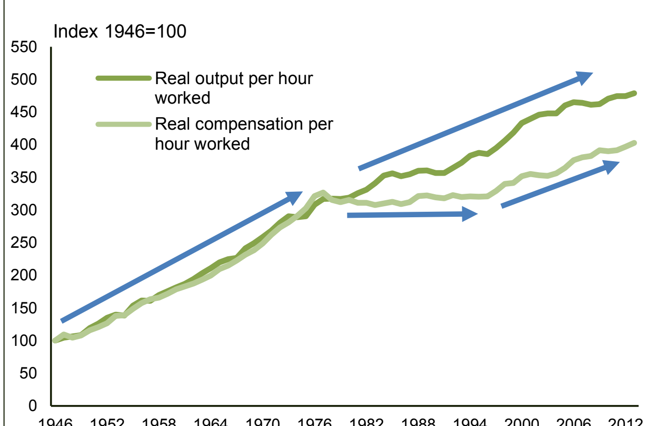
Source: Statistics Canada

CHART 10: INCOME SHARE OF THE TOP 1% AND 0.1% IN CANADA & THE U.S.

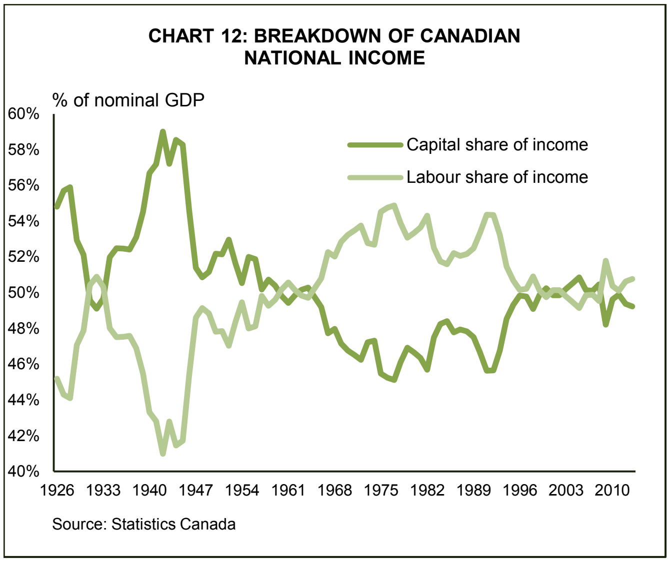


Source: Emmanuel Saez, Statistics Canada

CHART 11: CANADIAN LABOUR PRODUCTIVITY & COMPENSATION



Source: Statistics Canada



tandem with productivity (real output per hour worked). There was, however, a major setback in the 1980s, which likely reflected the impact of high inflation on curtailing real (after-inflation) compensation because wage contracts did not keep pace with the unexpected rise in the cost of living. The breakdown between productivity and income growth continued well into the 1990s, likely reflecting the deep recession and jobless recovery that followed.

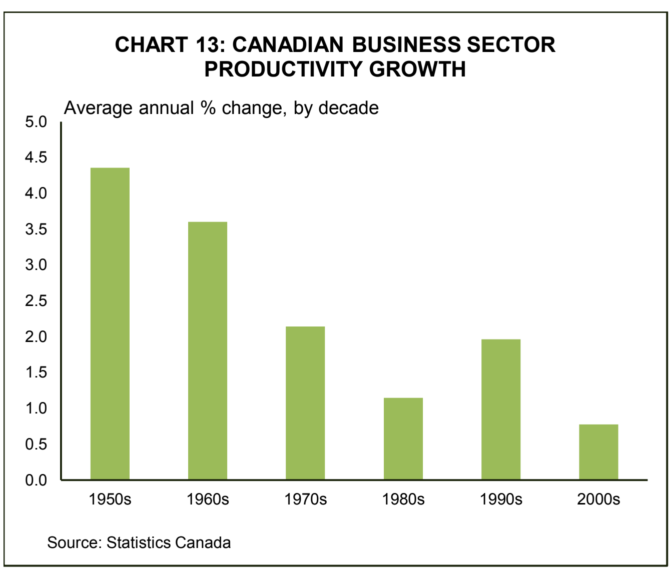
However, from the mid-90s to today, workers have once again benefited from rising compensation broadly tracking productivity growth. This likely reflects the demand for labour across a broad number of occupations. Prior to the 2008 recession, Canada was experiencing 30-year low unemployment rates, with labour shortages in parts of the country. While Canada lost hundreds of thousands of jobs during the 2008/09 recession, the recovery in employment has been more robust than in many other advanced economies. There have also been skill shortages in selected occupations in many parts of the country. This labour demand has been a catalyst for household income growth in line with productivity growth (Chart 11). Unfortunately, the core problem in Canada is that productivity growth has been very slow, which has in turn constrained the income to be distributed across workers (Chart 13).

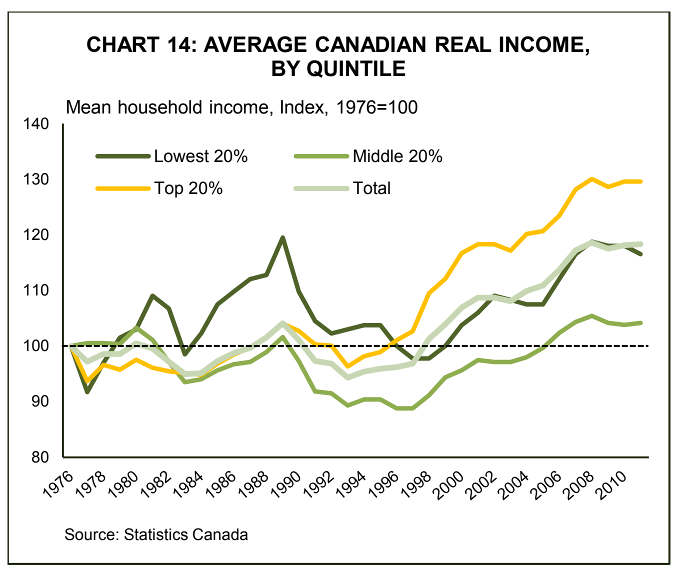
…but income gains have been limited and skewed

It is striking just how slow income growth has been. From 1976 to 1998, real (after-inflation) average family income only increased by 1.3%. Then income growth improved, rising 17% from 1998 to 2011. Looking at the bottom 20% of the income distribution, compared to the middle 20% and then top 20%, one can see how income inequality has increased (Chart 14). Real average income in the bottom 20% of earners rose close to 20% from 1976 to 1989, but then gave up all of its gains by 1997 before reversing course and advancing back up just shy of 20% since 1998. This roller coaster ride gives the impression that gains have been made, but it is important to highlight that the level of income for the average earner in the bottom 20% of the income distribution was only $15,500 in 2011.

The story for the middle 20% of income earners has been comparatively poor. Average income fell 9% between 1976 and 1998, but while income growth subsequently picked up it was not until 2006 that income was back to its 1976 level.

For the average income earner in the top 20% of the income distribution, real income was largely unchanged until



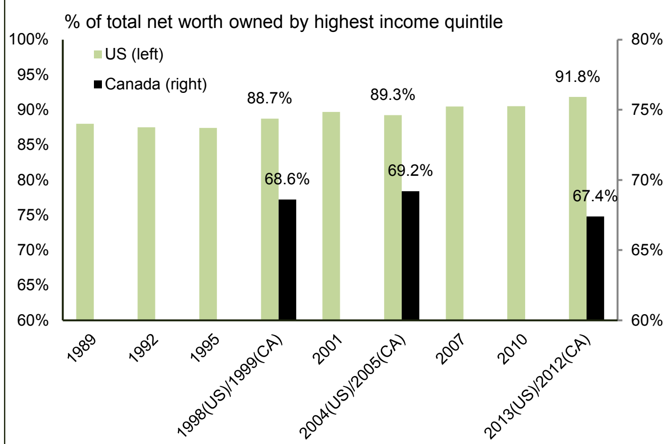


Wealth Inequality Between the US and Canada

This paper focuses on income inequality, but wealth inequality is an important dimension as well. The wealth distribution perhaps illuminates a more tangible notion of inequality since a stronger net worth position generally translates into greater ownership of physical assets and luxury goods, which are often viewed as demonstrating a higher quality of life. However, the Canadian data on wealth across the income spectrum is limited to three data points that come from the Survey of Financial Security. Nevertheless, the data does show that the story told by wealth inequality is much the same as with income, especially with regards to the U.S.-Canada cross-border comparison. As the accompanying chart shows, the distribution of wealth is heavily skewed towards high-income families in both countries. In Canada, nearly 70% of all net worth is held by the top 20% of Canadians. Two aspects of the chart are noteworthy. First, much like the Gini coefficient in Canada, this figure has not much changed since the late-1990s. In fact, the figure has even fallen slightly since the first Survey of Financial Security in 1999. Second, the share of wealth held in Canada by the top income quintile pales in comparison to the US. According to the 2013 Survey of Consumer Finances, nearly 92% of all net worth is held by the top 20% in the US. This share has also increased consistently over time, from 87% in 1992 and 89% in 1998.

While the concentration of wealth in Canada is less than in the U.S., the overall data masks a vulnerability in Canada that is worth noting. By far, the most important source of both asset and debt growth over the last 10-15 years has been related to real estate. While Canadians across the income spectrum have benefited from the housing boom, it is likely the case that wealthier households have more diversified holdings of assets on their balance sheet. Middle income households likely hold a greater share of their balance sheet wealth in their principal dwelling. If a housing correction occurs, the distribution of net worth across the income spectrum could shift, leading to higher wealth inequality. While TD Economics expects a soft landing in the Canadian housing market, there is evidence of excess valuation in real estate, which poses a risk.

SHARE OF NET WORTH HELD BY THE TOP 20%



Source: Statistics Canada Survey of Financial Security, US Census Bureau Survey of Consumer Finances

the mid-90s, but then increased close to 30%.

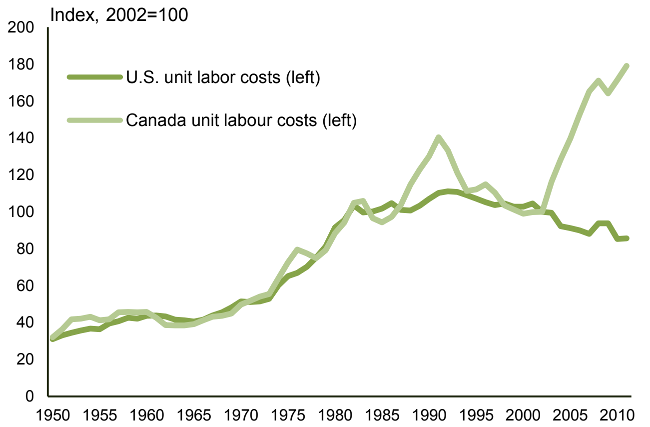
The conclusion is that weak productivity growth constrained overall personal income growth, but a rising share of income has gone to higher income earners over time. This is consistent with the forces of globalization and technological change, which raised demand for high skilled workers and diminished demand for middle skilled workers. Low income earners did experience income growth since 1998, but the level of income remained a huge obstacle to their standard of living.

Policy implications

The picture painted by the data for Canada is complicated, as it shows rising vulnerability and risks associated with higher income inequality. However, it is difficult to assess whether the level has reached a point that it threatens economic growth. For example, social mobility is not yet flashing a major warning signal and the Gini coefficient is relatively stable, albeit higher than in the past. Nevertheless, there is a legitimate concern that income inequality in Canada may start to rise and social mobility could decline in the years ahead.

Most worryingly are the competitive implications for Canada from the rise of income inequality in the United States. America is willing to pay its high-skilled workers significant premiums, but at the expense of their low and middle skill workers. Yet, Canada must compete with these firms for talent. America has stronger productivity, which also puts Canada at a disadvantage. Meanwhile, the bulk of the gains from productivity in the U.S. have gone to capital, meaning that America is a more competitive, lower cost producer. A good example of this is the proliferation

CHART 15: RELATIVE MANUFACTURING UNIT LABOUR COSTS



Source: Bureau of Labor Statistics

of right to work states, which has diminished compensation south of the border relative to that in Canada. These trends are captured in the dramatic shift of unit labour costs (Chart 15). The appreciation of the Canadian dollar has also contributed to the decline in Canadian competitiveness. While the currency has lost some of its gains this year, it should be stressed that counting on a weaker exchange rate to reverse Canada's competitive disadvantage is not a profitable strategy to address the challenge.

Other factors that could aggravate inequality in Canada are the prospects for sustained modest economic growth which may constrain public support for policies aimed at income redistribution. This, in turn, raises the spectre of lowering social mobility. Furthermore, the pressures from globalization and technological change are unlikely to abate. Inequality in Canada has not risen as much in recent years because of many good middle income jobs in resources and real estate sectors. However, commodity and real estate booms do not last forever, suggesting that income inequality could rise if these sectors lose momentum.

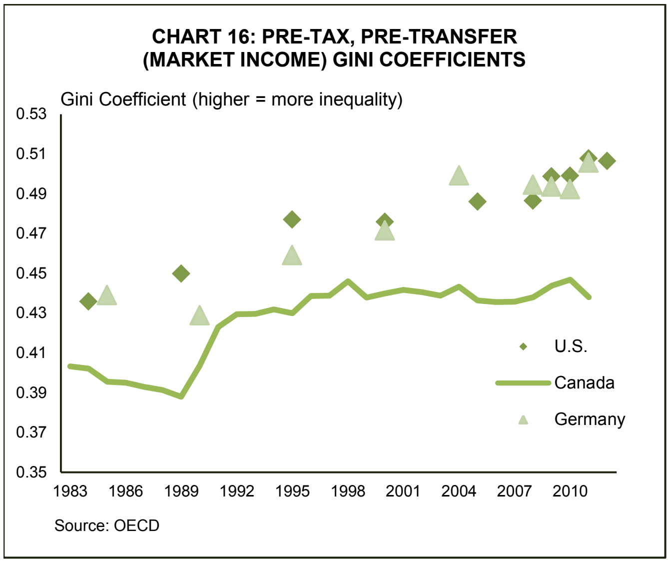
Taking on this issue is an enormous task for policymakers. Given that labour income is being constrained by weak productivity growth, a clear policy recommendation to strive for improvement on this front. The problem is that Canada has already made significant attempts to do so with seemingly little effect. Business productivity remains extremely weak relative to other countries, like the United States, despite our best efforts. Some avenues for further policy efforts remain, as there are structural factors holding back productivity. It is well known that Canada, being a small economy, has fewer large-scale firms compared to the United States. Canada needs to incent firms to grow and expand in scale or plug into global supply chains. The increasing reliance on commodity production also restrains productivity growth as more resources must be accessed from more difficult or more expensive sources. While resources will remain a critical contributor to economic growth and prosperity, policymakers need to encourage economic diversification and a shift towards production of higher value added goods and services. The nation also needs to do more commercially-oriented research and development.

There are policy hurdles to overcome, as well. This includes the low effective tax rate on small businesses relative to the general corporate income tax, which effectively incents firms to stay small. Canada is also a relatively high cost location for business, partly reflecting regulatory costs from federal, provincial and municipal governments. There is also a business and cultural dimension – Canadian firms invest less in machinery and equipment than their international peers and business leaders in Canada tend to be more risk averse. The simple reality is that no single factor accounts for Canada's weak productivity performance. It is a myriad of influences that have accumulated into a deep fundamental challenge.

Beyond putting in policies aimed at incenting strong productivity growth to increase income in the economy, policymakers should take income inequality considerations into their decision making process. The lesson from the 1990s was that when policy decisions fail to incorporate income distribution implications or do not worry about rising inequality, it is a recipe for less equitable outcomes.

A natural question is whether policymakers should seek to reduce market income inequality or after-tax and transfer income inequality. With respect to the former, governments have limited direct control on market incomes, which are set on the basis of supply and demand for labour in open and competitive markets. They can set wages for public sector workers, but there are implicit constraints on how far public wages can deviate from private sector wages without creating unintended and undesirable misallocations of labour in the economy. Policymakers can set minimum wages, but this is a limited tool for dealing with wages across the entire economy.

Market income inequality is also complicated because it can be high for either just or unjust reasons. For example, vibrant cities in the U.S. that have a significant concentration high value economic activity (like Silicon Valley) have very high income inequality; meanwhile depressed cities can



have very low inequality. If higher market income inequality reflects economic dynamism, then it is far more appropriate and acceptable. However, if a high level of inequality is a reflection of entrenched interests and the ability of high income earners to capture inappropriate rents, then it is a very damaging outcome. Ultimately, one cannot assess exactly how much market income inequality is appropriate and it is difficult for governments to manage incomes set in the market.

Governments do, however, have direct control of taxes and transfers that affect the incomes people live on. OECD analysis argues that the threat to economic growth comes from inequality after taxes and transfers, not before. Canada's relative performance on this basis is significantly less favourable than many other advanced economies.

Consider Germany, which has high market income inequality, but low after tax/transfer inequality (see Chart 16). In Canada, market incomes are well below those in Germany, but income inequality after taxes and transfers is much higher than in Germany (Chart 17). This suggests that Canada could do more in terms of redistribution of income. Indeed, Canada's tax system is not as progressive as many might think and the transfer system is not as significant as in many other countries (Chart 18). For example, Canada has the 9th lowest level of market income inequality within the group of OECD countries, but its ranking drops to 19th position after taxes and transfers.

The usual push back against calls for more income redistribution is that higher taxes and increased transfers will slow economic growth and hamper prosperity. However, this need not be the case. A 2014 IMF study entitled "Redistribution, Inequality and Growth"[2] had three key findings that contribute to the case for leaning against income inequality. The findings were:

- More unequal societies tend to redistribute more.
- Lower net inequality is robustly correlated with faster and more durable economic growth, for a given level of redistribution.
- Redistribution appears generally benign in terms of its impact on economic growth; only in extreme cases is there some evidence that it may have a direct negative effect on growth.

This tells us that policies that lean against rising income inequality can be beneficial, but those policies need to be smart ones that do not undermine productivity and competitiveness in the economy. For Canadian governments, this includes the need to balance income redistribution efforts with other important policy considerations. These include a growing global fight for talent and declining labour cost competitiveness with the United States. Moreover, there are limits to the scope of income redistribution. Even if one was to raise income taxes on the top 1% of earners dramatically, there are so few people in this category that the result would barely move the needle on income inequality. Taxes for middle income households would have to rise as well, but this is a group that is now under considerable pressure.

While raising taxes on higher income individuals is one way to redistribute income, it is not the only option open to governments. Case in point, policymakers can move to "means test" more government programs and services. In recent years, governments have been moving away from programs that were set up on the principal of universality.

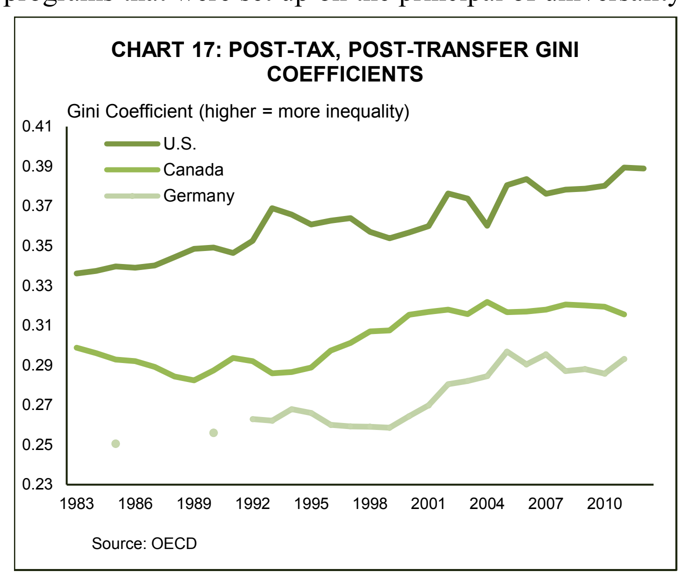


CHART 18: REDISTRIBUTIVE IMPACT OF TAXES AND TRANSFERS

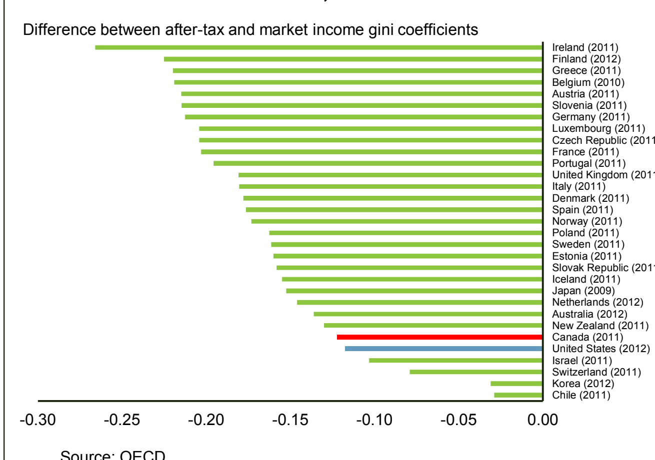
Yet, a number of programs persist where assistance could be better targeted to those most in need, thus taking pressure off the need to raise taxes.

Lastly, the policy debate over whether to focus on market income or after-tax, after-transfer income misses an important point. Governments may not have direct control most private-sector wages, but through effective policy design they can help to build the foundation upon which market incomes grow. While the ultimate goal of public policy should be to narrow the gap between after-tax and transfer incomes between higher and lower income households, a preferred route to achieving this end is to knock down barriers faced by disadvantaged Canadians to achieving better success in the job market. In other words, a hand up is preferred to a hand out. For example, education and skills development allows individuals to unlock their full potential. Health policies can allow individuals to take a more active role in the labour market. Social programs and policies can help the disadvantaged to get on their feet and become more engaged.

Today, governments already spend significant resources indirectly improving labour outcomes of individuals and promoting social mobility, which is partly why Canada does not rank badly on market income inequality. However, there is scope for improvement. For example, low and middle income families have less access to high quality early childhood education programs than the wealthy, giving the children of the latter an advantage in life. While access to primary, secondary and post-secondary education is generally good, previous research by TD Economics has argued that student support programs for post-secondary education should be more means tested to provide even greater support to those in need, particularly given the ever-rising tuition costs. Efforts to promote education could pay dividends as low income parents often underestimate the value of post-secondary education and overestimate the cost. Many professional programs are becoming extremely expensive (like law, medicine, graduate business schools), which can lead to questions about equal accessibility for youths from lower income backgrounds. In terms of skills, Canada's performance on essential skills, such as literacy and numeracy, could be enhanced. More investment in affordable housing could help provide shelter and improve health outcomes for poor members of society, which is essential to allow them to reengage in the labour market. When low income individuals attempt to improve their fortunes, the resulting increase in employment income can often result in a step loss of government support programs, creating a major disincentive. More progress could be made on reducing barriers to success for immigrants and aboriginals. Pension reforms could also provide more income security later in life. The list could go on, and on.

TD Economics has written on many of these subjects in the past and has detailed many of the possible policies that could help improve the fortunes of disadvantaged Canadians. A full list is beyond the scope of this paper. However, it should be evident how policymakers can have a great influence on shaping income inequality beyond directly impacting market income or through taxes and transfers. Moreover, many of these initiatives can help to boost productivity and competitiveness. From a strategy perspective, the most effective approach is likely a balanced one, using all three channels of direct and indirect influence

CHART 19: REDISTRIBUTIVE IMPACT OF TAXES AND TRANSFERS, OECD COUNTRIES



on market incomes, combined with changes to the tax and transfer system.

Conclusions

Canadians can be proud of our economic and social system. Canada has an average level of income inequality relative to other advanced economies, and social mobility is relatively high. However, there are legitimate concerns about the rise in income inequality in recent decades and there are forces that could push it higher in the years to come, which could ultimately jeopardize social mobility. In particular, the pressures from technological change and globalization will persist. If the commodity and real estate sectors soften, middle skill workers could be under even greater pressure. Moreover, the competitiveness challenge of rising U.S. inequality threatens to push Canada towards higher income inequality. And, the modest economic growth outlook could add to the inequality strains in the Great White North. These risks imply that policymakers at all levels of government should think about how to lean against the incipient inequality pressures, but this must be done in a constructive way. No growth and no income would make everyone equal, but would be the worst possible outcome. The goal is to have rising income with fair distribution, a necessary condition for which is a productive and competitive economy. The requisite policy leaning likely requires a mixed approach involving direct and indirect efforts to influence market incomes, combined with a progressive tax system and an effective transfer system that limits negative distortions on the economy. The challenge for Canada is to maintain its economic and social model in a world of growing inequality; and, this requires more consideration of income inequality implications when making policy decisions.

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ENDNOTES

1 De Serres, Alain and Nicolas Ruiz, 2014, "Growth and inequality: A close relationship?", OECD Forum

2 Ostry, Jonathan D., Berg, Andrew and Charalambos G. Tsangarides, 2014, "Redistribution, Inequality and Growth," IMF Discussion Paper