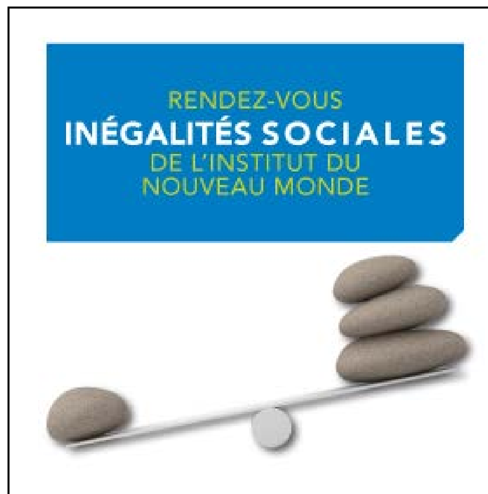

Inequality in Canada: Demystifying a Compelling Issue and Influencing Policy

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Inequality has always existed and has many causes: birthplace, family, environment, economic and social institutions, individual talent and pure luck. However, income inequality has been growing over the past 30 years: “Study after study has reached the same conclusion: since the 1980s, economic growth has benefited mostly the rich, while the poor and the middle class have seen their conditions decline” [translation] (Grammond, 2011). Last year, according to a report by the World Economic Forum in Davos, “severe income disparity is one of the biggest global risks” [translation] (Bérubé, 2012), stoking popular anger and threatening economic growth. Since the major economic and financial crisis of 2007–2008, the OECD has said that stimulating economic growth and reducing inequality “can and must go hand in hand” [translation] (Desrosiers, 2012). The International Labour Organization (ILO, 2008) produced a report on the recent rise of inequality in developed countries. It found that between 1990 and 2008, in about two thirds of the countries for which data are available, the income of high-income households expanded much faster than was the case for their medium- and low-income counterparts. “Likewise, during the same period, the income gap between the top and bottom 10 per cent of wage earners increased in 70 per cent of the countries for which data are available” (p. 1). They add that this was a period of relatively rapid economic growth and strong job creation.

According to a Conference Board study, Canada is among the countries experiencing the strongest growth (Desrosiers, 2011). Since 1980, the Gini coefficient, which measures inequality, increased by 19% for market income for all economic households. The government was unable to prevent this rise in inequality, which rose by 12% after taxes and transfers. The share of market income captured by the richest 1% in Canada, which was 8% in 1982, grew sharply to 13.3% of all income in 2010. Even after taxes and transfers, the share of the 1% rose from 6.3% to 9.9% during the same period.

What Is Causing These Changes?

For about 30 years now, income inequality has been growing in most of the developed countries, and wealth is generally more concentrated at the top of the social pyramid. What are the reasons behind this?

The market

Many analysts and observers believe that income inequality is created or compounded by market forces.

1. Income inequality appears to be attributable largely to labour market supply and demand. Individual talent and the demand for these skills are the key criteria for setting salaries, key determinants of income levels and the resulting balance (or imbalance).

2. The technological changes of recent decades have polarized the labour market, rewarding highly skilled workers at the expense of those with very few skills. This means that university degrees have become increasingly important in income distribution.

3. Trade globalization has resulted in polarized incomes: this globalization is putting increasing pressure on low-skilled workers in developed countries to accept lower wages while driving up the wages of more-qualified workers. Competition among workers and among countries appears to have greatly contributed to growing inequality.

Primarily a policy choice: the decline of redistributive institutions

All developed countries have experienced these phenomena. So why is it that countries such as Sweden and Germany, each with a per capita GDP almost identical to Canada, are so different with respect to income inequality? The answer lies in the fact that countries make policy choices consistent with their values and priorities. They decide who pays how much tax, the minimum income level required to make a decent living, the extent to which society has a duty to not leave anyone behind, and how to give everyone an equal chance at a good quality of life. The extent of inequality, poverty and excessive wealth is primarily a policy choice.

According to a number of economists, historians and political scientists, the cause of the recent inequality growth is the decline of economic and political institutions favourable to workers, institutions that are being replaced by the neoliberal model—together with a weakening of social programs, the privatization of public services, market deregulation (particularly financial markets), and greater labour market "flexibility" at the expense of

labour protections. This is especially the case in English-speaking countries. They point to institutions as having a key role in forming a policy consensus in political and economic terms as well as in terms of social standards.

The approach taken by national governments greatly influences levels of inequality: industrialized countries have governments that control and redistribute between 30% and 50% of the resources produced by the national economy, meaning that governments cannot help but have an impact on income and wealth distribution. Each country is faced with generally the same constraints (globalization, technological innovation, economic conditions, competitive markets). However, each country makes economic and political choices that influence the type of economy and income distribution within society.

Some consensus

There is consensus on some of the sources of inequality: 1) the increasing share, in the total income of individuals, of corporate dividends and capital gains, which are the preserve of a very small segment of the population; 2) the increasing gap between the lowest and highest salaries; and 3) the decreased effectiveness of the redistribution mechanisms in welfare states.

The Decline of the Middle Class

The ILO (2008, p. 4) argues that "in the face of strong wage moderation, workers and their families became increasingly indebted in order to fund their housing investment decisions – and sometimes consumption decisions as well." According to the argument, financial innovation paved the way for higher household debt, a situation particularly acute in Canada. Financial globalization arising from the deregulation of capital flows is also cited as a cause of increased income inequality, by intensifying systemic banking crises, which occurred ten times more frequently in the 90s than in the 70s. "Such increased instability typically comes at a steep cost to low-income groups" in terms of job losses, where investment slumps have a significant impact on unemployment. Moreover, financial globalization has reinforced the downward trend in wages.

In a study on the financialization of the U.S. non-financial sector between 1970 and 2008, Lin and Tomaskovic-Devey (2011) noted that it contributed to the growth in income inequality. An increasing proportion of corporate revenues depended on profits

realized in the finance sector, which resulted in greater bargaining power for owners, executives and highly skilled workers compared to other workers. Moreover, this finance conception of the firm reduced investment and managerial commitment to production and marginalized the role of workers. This resulted in the gradual exclusion of labour from wage-setting process, driving down workers' wages while increasing the pay of executives and the highest-skilled workers.

The reduced equalizing effect of tax policy and social programs was blamed as one of the key drivers of increasing inequality. According to the OECD (2011), Canada's ability to reduce inequality plummeted from 90% to 20%. Lower employment insurance benefits and other transfers also contributed to increased income inequality, even if taxation has a limited role. They also noted that tax credits mostly benefit the wealthiest. Frenette, Green and Milligan (2008) argue that transfers were able to absorb increased market inequality in Canada during the 80s, but were unable to contain it in the 90s.

The Wealthy Outpacing the Rest of Society

Several factors explain the faster income growth for the wealthiest, the most important being social norms, corporate governance and taxes.

Social norms

Social norms have a significant impact on taxpayer-funded government programs, as well as on the distribution of productivity gains, particularly by defining what is fair and adequate compensation. According to Parienty (1999),

> The assumption that the labour market, like everything else, responds to supply and demand variations is not very satisfactory. While in theory, compensation should relate to one's contribution to production, this contribution is generally unobservable, since labour is a collective effort. The gap in pay between skill levels is often more a convention than an objective measure of one's contribution to production. [translation]

Along these lines, Krugman believes that, in terms of social norms, CEO salaries serve as an illustrative example, since these salary increases are in no way linked to performance. While major corporations have experienced steady average growth rates in line with annual GDP over the last 50 years, the 100 highest-paid CEOs went from being paid an average 40 times higher than the average full-time worker in the U.S. to

over 367 times higher in the early 2000s (Krugman, 2007). The Institute for Governance of Private and Public Organizations (2012) has observed the same phenomenon in Canada; the median compensation of corporate heads was up to 150 times higher than the average private sector salary in 2010, compared to being 60 times the average salary in 1998. While Japan is home to the world's largest and most prosperous multinationals, its CEOs are paid only 16 times higher than the average worker (Stiglitz, 2012). It appears that social norms are key determinants.

Corporate governance

According to Mousli, "executive pay since the 90s has skyrocketed as a result of corporate governance practices" [translation] aimed at more closely aligning executive and shareholder interests. "In order to have the operating officer concentrate on maximizing the stock price, a major part of executive compensation is made up of stock options or bonus shares, so that this compensation rises sharply when the stock price climbs" [translation] (2013, p. 74). However, this type of pay policy is not without risks and significantly increases the pay of their primary recipients:

> Opportunistic CEOs could generate a lot of money by making decisions that personally benefit them in the short term but are disastrous for the business in the medium term. There is no rational explanation for these kinds of pay packages. In maximizing revenues, there is no direct link between company size or sales figures and CEO salaries. Neither is there a strict correlation between pay levels and corporate performance or with the economy. [translation]

This type of behaviour is encouraged by the lack of information that would allow shareholders to adequately assess executive performance and by the board of directors' lack of independence from CEOs, "who hold a lot of power since they hold both information and authority" [translation]. According to Bebchuck and Fried (2004), the dominant position of executives in negotiating salaries with shareholders appears to be a major factor in high compensation practices, which is a form of rent extraction. According to Stiglitz (2012, p. 31), competition should normally limit disproportionate executive compensation. However, governments must ensure that boards of directors are sufficiently independent, or else CEOs can get away with outsize bonuses. As reported by Veall (2012, p. 10), Jensen and Murphy (2004) wrote that CEOs have a strong incentive to control corporate information that determines their compensation. Veall argues that an environment of insider control seems likely to foster excessive CEO compensation. (p. 21).

Taxes

In a sample of 18 major OECD countries from 1975 to 2009, Piketty, Saenz and Stantcheva (2011) noted a strong correlation between high incomes and marginal tax rates: “Interestingly, the link between top rate cuts and top income share increases is strong in English speaking countries.” The erosion of progressive tax policies is not limited to the U.S.: “In all countries, the highest marginal tax rates have been dropping and the number of tax brackets has been reduced” [translation] (Vallée, 2000, p. 42). According to the OECD (2011), “the share of overall tax burdens borne by high-income groups has declined in recent years (e.g. where tax schedules became flatter and/or where tax expenditures mainly benefitted high-income groups).” This phenomenon was also noted by the ILO, which argues that “taxation has become less progressive in the vast majority of countries and thus less able to redistribute the gains from economic growth. This reflects a cut in taxes on high incomes.” (2008, p. 3) We draw two conclusions: the first centile (the wealthiest 1%) is sensitive to tax changes, particularly the MTR, which has dropped significantly in developed countries. This sensitivity ends up capping growth in high incomes when the MTR is high, while a low rate promotes an increase in income share for the first centile.

How do taxes have an impact on the first centile’s market income (i.e. before transfers and taxes)? According to Leigh (2011, p. 165), a high MTR affects the first centile’s income share two ways: in the short term, it is an incentive to work less, and in the longer term, it has a dynamic effect on capital accumulation. However, while the MTR may actually provide an incentive for some to work less, it may be offset by the reverse effect in others: “Higher tax rates can increase work effort if there is a large enough ‘income effect,’ whereby individuals have to work harder to achieve a given level of post-tax income” (Sefton, 2008, p. 613). The lagged effect on long-term capital accumulation works as follows: the wealthiest have a higher-than-average savings rate. These savings may become an income-generating investment, which can be passed down through inheritance, thereby perpetuating inequity. In other words, these “excess” (unused) incomes invested in savings may become a source of additional income, thereby further concentrating incomes at the top.

Piketty, Saez and Stantcheva (2011) argue that the marginal tax rate has another impact on the increase of the P99-P100; when the MTR is high, it reduces the after-tax gains from the negotiated salaries of high-income earners, discouraging them from working

harder to earn higher pay. When it is lower, negotiating higher compensation becomes "profitable." However, this additional income is not linked to higher employee productivity, making it compensation that is above what is economically optimal, since it is a zero-sum game; one's gain is another's loss. In other words, this constitutes rent extraction.

Inequality: A Social Problem

Although Canadians are generally better off, growth over the last 25 years has benefited the wealthiest much more. This trend, which has been increasing in developed countries since the 2000s, goes hand in hand with growing economic inequality and the accompanying economic and social problems (Stiglitz, 2012). According to Wilkinson and Pickett (2010), there is a strong correlation between income inequality and a host of economic and social problems. They conclude that the more evenly a society's resources are distributed, the more its population is better off. As philosophy professors David Robichaud and Patrick Turmel pointed out so eloquently in their book *La juste part*, no one becomes wealthy on their own, since it is impossible to separate each person's share of the overall production from social wealth. Collective intervention and wealth redistribution makes social mobility, economic growth and the development of society as a whole possible. There is no economic, social, moral or ethical justification for deepening inequality. Since it is a societal choice, let's allow citizens to choose.

Three Recommendations for Reducing Inequality

Elected officials and the government have the power to act. Of all the measures available, three appear to be particularly appropriate.

A decent income and training support: The labour market is more competitive than ever, and workers are sometimes unprepared for these changes. Better coordination between worker training and employment insurance could effectively equip workers for these social risks. For low-income workers and individuals unable to return to the labour market, a social safety net able to provide a decent living […]

A more progressive tax system: The tax system has become less progressive since the 80s, with lower marginal tax rates, the appearance of tax credits, a lower number of tax brackets and a growing share of indirect, regressive taxes. The elimination of tax

credits favouring high incomes, including favourable treatment for capital gains and corporate dividends, and high marginal tax rates would return balanced income distribution.

Democratization of economic and tax decisions: Any economic and tax policy reform would benefit from having the public included in the decision-making process. It is the public who is the most affected by these changes, and public wisdom can complement academic expertise. Including “ordinary” citizens in the process resets the power balance between the general public and powerful (corporate or labour) organizations that have a say in public discussions mainly to promote special interests. Lastly, including the public gives them a better understanding of the issues and increases their ability to act on these issues.

A Strategic Conference on Social Inequality

The Institut du Nouveau Monde (INM) believes that a major debate is needed now more than ever before. It has been clearly demonstrated that this issue affects everyone. The INM is therefore proposing to hold a strategic conference on social inequality in order to bring forth clear societal will on preventive health and on reducing social inequality as part of calm and constructive public debate. As a major debate-provoking exercise, the purpose of the Strategic Conference would be to bring forth clear societal will on reducing social inequality. Several events will be taking place over the coming months:

- **Inform:** Any informed debate must start with information. We have made background material on the issue available online. We will also organize an international conference, a paper and a scientific seminar on inequality.

- **Debate:** In order to allow the public to have their say and bring forth social choices, values and priorities for reducing inequality, we are undertaking a public-based, debate-provoking exercise that includes a travelling citizen panel, informal meetings across Quebec, a laboratory for social innovation and a national conference to tie everything together.

- **Propose:** We will undertake a series of meetings with policymakers in an effort to influence public policy in order to reduce inequality.

About the Institut du Nouveau Monde - Citizens, Ideas, Projects

The Institut du Nouveau Monde (INM) works toward increasing public engagement in democratic life.

The INM is a non-partisan organization active mainly in Quebec on issues surrounding justice and social inclusion, respect for democratic values and sustainable development principles, in a spirit of openness and innovation.

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