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# Special Report: The case for leaning against income inequality in Canada [1]

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**Source:** TD Economics
**Format:** Report
**Publication Date:** 24 Nov 2014

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Introduction:

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, tradeoriented 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 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.

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