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Communiqué

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C.D. Howe Institute study seeks key to faster growth and greater equality

Better health and education services for the young, financed by progressive expenditure taxes, appear to be the most promising route to higher and more equally shared living standards, says a C.D. Howe Institute study released today. The study notes that, although growth and equality are often seen as goals to be traded off against each other, the fact that slower growth in the Canadian economy over the past two decades appears to have been accompanied by rising income disparities points to the possibility of doing better on both fronts in future.

The study, *Equality and Prosperity: Finding Common Ground*, was edited by William B.P. Robson, a Senior Policy Analyst at the C.D. Howe Institute, and William Scarth, Professor of Economics at McMaster University and an Adjunct Scholar of the Institute.

In one paper, Robson and Scarth bring together a comprehensive survey of possible reasons for Canada's recent experience. In another paper, the late Carleton University economist W. Irwin Gillespie undertakes a detailed examination of the effects of taxes and government spending on various income groups. A third paper, by David Love, of Brock University, and Huw Lloyd-Ellis, of the University of Toronto, is a modeling exercise focusing on investments in human and physical capital. The book also includes comments by James Davies from the University of Western Ontario and John Helliwell from the University of British Columbia.

The study finds some common explanations for growing disparities, such as globalization and deregulation, unconvincing. It also concludes that possible responses, such as protection and labor market intervention, are unlikely to be helpful. On the other hand, theory and evidence point both to the comparative effectiveness of government taxes and transfers in mitigating uneven market outcomes and to the importance of promoting investments in human capital for both growth and equality.

In their introduction to the study, Robson and Scarth argue for a two-pronged strategy. On the tax side, governments should rely more heavily on progressive expenditure taxes, which redistribute purchasing power but discourage saving and investment less than income taxes. On the spending side, governments should focus on health and education services for the young — human capital investments of a kind that markets may not make. These strategies, Robson and Scarth conclude, hold out hope for both faster growth and more even distribution of wealth in Canada in the future.

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- 30 -

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Equality and Prosperity: Finding Common Ground, Policy Study 30, edited by William B.P. Robson and William Scarth (C.D. Howe Institute, Toronto, June 1997). 170 pp.; $14.95 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-408-X.

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Communiqué

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Une étude de l'Institut C.D. Howe recherche la clé d'une croissance accélérée et d'une égalité accrue

De meilleurs services de santé et de meilleurs services d'enseignement pour les jeunes, financés par des impôts progressifs sur les dépenses promettent d'être la meilleure voie vers un niveau de vie plus élevé et partagé plus équitablement, affirme une étude de l'Institut C.D. Howe publiée aujourd'hui. Cette dernière ajoute que, bien qu'on perçoive souvent la croissance et l'égalité comme des objectifs qui se font concurrence, il reste que la croissance plus lente de l'économie canadienne au cours des vingt dernières années a été accompagnée d'une disparité accrue des revenus; ceci semble donc indiquer la possibilité de faire mieux sur les deux fronts pour l'avenir.

L'étude, intitulée *Equality and Prosperity: Finding Common Ground (Égalité et Prospérité : à la recherche d'un terrain d'entente)* est dirigée par William B.P. Robson, un analyste de politique principal de l'Institut C.D. Howe, et William Scarth, professeur d'économique à l'Université McMaster et attaché de recherche de l'Institut.

Dans l'un des documents de l'étude, Robson et Scarth rassemblent dans le cadre d'une enquête exhaustive les raisons probables de l'expérience canadienne récente. Dans un autre document, feu W. Irwin Gillespie, économiste de l'Université Carleton, donne un examen détaillé de l'effet des taxes et des dépenses gouvernementales sur des groupes à diverses catégories de revenus. Un troisième document, dont David Love de l'Université Brock et Huw Lloyd-Ellis de l'Université de Toronto sont les auteurs, est un exercice de modélisation qui porte sur l'investissement dans le capital humain et physique. L'ouvrage comporte également des commentaires de James Davies, de l'University of Western Ontario, et de John Helliwell, de l'Université de la Colombie-Britannique.

L'étude établit que certaines raisons traditionnellement invoquées pour expliquer l'accroissement des disparités, telles que la mondialisation et la déréglementation, ne sont pas convaincantes. En outre, elle établit que certaines mesures éventuelles, comme la protection et l'intervention sur le marché du travail, ne seront probablement d'aucune utilité. D'autre part, la théorie et les preuves indiquent que l'efficacité comparative des taxes et des transferts gouvernementaux peuvent aider à atténuer les inégalités du marché et qu'il importe d'encourager l'investissement dans le capital humain pour favoriser la croissance et l'égalité.

Dans leur introduction, Robson et Scarth préconisent une stratégie axée sur deux fronts. Dans le domaine des taxes, les gouvernements devraient se fier davantage à des taxes progressives sur les dépenses, qui redistribuent le pouvoir d'achat, mais qui encouragent plus à l'épargne et à l'investissement que ne le font les impôts sur le revenu. Dans le domaine des dépenses, les gouvernements devraient se concentrer sur les services de santé et d'enseignement pour les jeunes — soit des types d'investissements dans le capital humain que le marché n'est pas en mesure de faire. Comment le concluent Robson et Scarth, ces stratégies donnent l'espoir d'une croissance plus forte et d'une répartition plus équitable de la richesse au Canada pour l'avenir.

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Contents

Equality and Prosperity:
Must We Choose?

William B.P. Robson
and
William Scarth

Over the past quarter-century, two economic developments have prompted concern among Canadians in general and economists in particular. On the one hand, the rapid productivity growth rates and rising incomes of the immediate postwar decades have been replaced by much slower improvements. This development threatens absolute declines in living standards as the proportion of Canada's population in the labor force declines in coming years. On the other hand, a tendency toward more even distribution of income during the postwar years has been replaced by a tendency for greater inequality in the distribution of market incomes. A steady rise in redistribution through government, however, has kept distribution of incomes after taxes and government transfers relatively unchanged.

It is easy to infer that these developments are related. But it is not obvious how. Does slower growth produce inequality? Is it the other way around? Or are both phenomena joint products of something else that changed 25 years ago?

It is also common to hear demands that something be done about these trends. But it is not obvious what should be done. The pressure of interest payments on government revenue has been forcing a hard look at the efficacy of spending and the costs of taxation. At the same time, the prospect that a growing portion of the population may miss opportunities most Canadians take for granted because of inadequate resources is alarming. The gaps in our knowledge and our confidence in the tools at our disposal are frustrating.

These problems inspired a conference that took place as part of the annual meetings of the Canadian Economics Association on May 31, 1996, the proceedings of which this book records. The conference addressed the question of whether two fundamental objectives of economic policy — increased efficiency and increased equality — are complementary or conflicting objectives. Does success on one front improve or harm the prospects for success on the other?

Review of the Key Issues

Why might equality and prosperity be competing objectives? The principal reason for concern on this front is that wealth must be created before it is redistributed. Taxing the creators of wealth to finance redistribution can discourage wealth creation and divert energy from entrepreneurial activity toward rent seeking through the state. If the adverse consequences for efficient use of resources are felt not only on the level of national output and income at a particular point in time, but also on its rate of growth over time, then the implications of the tradeoff are very severe. As Richard Lipsey expresses it:

> All the other concerns of economic policy — full employment, efficiency in resource use, and income redistribution — pale into insignificance when set against growth....[F]or every $1 of purchasing power earned by someone in 1896, a person who is in the same position in the relative income scale today earns about $10 worth.*

But economists have long noted that there need not always be a tradeoff between equality and growth. When a system of decentralized markets fails to operate perfectly, it is possible — at least in

* Richard G. Lipsey, *Economic Growth, Technological Change, and Canadian Economic Policy*, Benefactors Lecture, 1996 (Toronto: C.D. Howe Institute, 1996), pp. 4–5.

principle — to design a government initiative that simultaneously raises efficiency (by ameliorating the underlying market failure) and lowers inequality. For example, aversion to risk on the part of individuals may lead to less innovative effort and less growth than society as a whole would like; a safety net to protect losers from destitution could offset this problem and boost growth. Alternatively, if inability to borrow against future earnings prevents part of the potential labor force from investing adequately in education, then human capital investment — and hence growth — may suffer; government subsidies to education would help in this situation.

There is a big difference between a theoretical possibility, which may apply in only limited circumstances, and a practical policy response. Many observers have come to believe that attempts to make improvements on both fronts at once are doomed to fail. Canada's attempt to pool risk through unemployment insurance, for example, is widely seen as having led employers and employees to adjust their behavior to garner transfers, hurting overall output and increasing inequality of market incomes. Redistribution can take many forms, however, and it may be that transfers to the less fortunate can be accomplished more directly and at less cost to efficiency through the direct provision of services by government, rather than through cash transfers that simply make individuals better able to cope in the marketplace.

In exploring the question of how Canada's average level of prosperity might be raised and how those gains might be widely distributed in the future, a host of diagnostic questions and prescriptive complications arise. The three papers and discussants' comments in this book provide some illumination of Canada's current situation and choices in this regard.

Overview of the Contributions

In the first paper, we, as the editors and conference organizers, provide a survey of Canadian evidence and possible explanations. We begin by summarizing the facts concerning trends in income distribution and the controversies involved in defining such things as poverty lines. There has been a trend toward increased inequality of market incomes over the past 20 years, with the position of younger, less educated individuals deteriorating in particular. Measures of inequality show a strong cyclical dimension as well, with inequality rising when unemployment is high. Redistribution by government has been an important factor in income distribution. Indeed, no significant increase in inequality is observed when income is measured on an after-tax basis, with all transfer payments from government included. Even so, a great many of the individuals in the bottom quintile of the income distribution receive incomes — even with transfer payments — that are well below familiar measures such as Statistics Canada's low-income cutoff.

We go on to discuss a number of the hypothesized explanations for the rising disparities in market incomes that have attracted attention in recent years — seven in all. These include:

- *globalization*, which can pull down the wages received by unskilled workers in developed countries toward the level prevailing in the developing countries;
- *the communications revolution*, which can make more pervasive the "winner-take-all" phenomenon;
- *deregulation*, which erodes institutions such as unions and minimum-wage laws that maintain higher wages;
- *sectoral shifts*, which can increase the non-accelerating inflation rate of unemployment;
- *skill-biased technical change*, which raises the premium received by individuals who have acquired more and better education; changes in macroeconomic circumstances, such as relatively higher returns to capital and more frequent and severe recessions; and
- *higher taxation*, which can raise the level of structural unemployment.

We give particular attention to questions of market failure that are central to each diagnosis of the rising inequality phenomenon, since, as noted above, it is the existence of market failure in a *laissez-faire* environment that generates the possibility of raising both efficiency and equality simultaneously. We conclude that a complete disentangling of these competing hypotheses is not necessary to arrive at a set of policy guidelines that can keep the undesirable effects of fiscal retrenchment on income inequality at a minimum. As fiscal priorities, we identify increasing reliance on a progressive expenditure tax (so that the harmful disincentive effects of other forms of taxation are not imposed in the act of redistribution) and raising the proportion of government programs directed toward health and education for the young as the equality-enhancing measures that are most promising for their effects on growth.

The other two papers in this volume pursue particular aspects of the prosperity and equality puzzle in greater depth, and the remarks of a discussant are included in each case.

Irwin Gillespie summarizes an extensive set of studies that estimate how many of the benefits of each government program go to the individuals and families at each point along the income scale, and how much of each tax is actually paid by those at each income level. By combining all these calculations, Gillespie estimates how much overall redistribution Canadian governments do, taking account of all aspects of both the tax and expenditure sides of the budget. Given the scope of his investigation, Gillespie had to make a great many assumptions along the way. While he explains the implications of varying some of these assumptions, a complete set of sensitivity tests is impossible.

Jim Davies, the discussant, injects a note of skepticism regarding incidence studies of this sort. For one thing, he is uncomfortable with the assumption that a person's position along the income scale (on a *pre*-tax-and-transfer basis) is *not* affected by government. Those who characterize the implicit tax rates of around 100 percent that arise from the interaction of many welfare programs with other parts of the tax-transfer system as a "poverty trap" would agree with

Davies in this regard. Nevertheless, Davies does agree with some of Gillespie's policy suggestions, such as a tax on bequests. Furthermore, Gillespie's call for maintaining education and health expenditures receives support from the other papers in the book. Thus, not all of the many disagreements regarding the specifics of incidence studies translate into disputes concerning policy.

The final paper in the volume is by David Love and Huw Lloyd-Ellis, who investigate a version of what is known as "new" growth theory. A key aspect of the model economy that forms the core of this detailed study is government spending on education, which, by making individuals more productive, raises both income equality and the overall rate of economic growth. Of course these expenditures must be financed, and the model incorporates disincentive effects as a result of decreased returns from working and saving / investing as a result of these taxes.

Scaling back government can lower tax rates, increasing incentives for private wealth generation and enhancing overall prosperity. But with fewer educational services available, a larger proportion of the population is unable to go on in school. The result is a more unequal distribution of income and a lower growth rate for the overall level of national income. When both sides of the budget are considered, it becomes an empirical matter as to whether the benefits of smaller government outweigh the costs. In Love and Lloyd-Ellis's simulations, the benefits of lower taxes win out, but the results are sensitive to various assumptions, including the share of the budget going to education and its efficacy in raising growth. Love and Lloyd-Ellis conclude that the analysis does not provide strong support for smaller government if the shrinking involves cuts in equality-enhancing areas such as health and education.

John Helliwell, the discussant of this paper, argues that more sensitivity testing is needed here as well. There are many reasons for the income distribution to affect the growth rate in addition to the specific mechanism modeled by Love and Lloyd-Ellis, and confidence in the numerical analysis could be enhanced by further consideration of alternative institutional settings. Nevertheless, Helliwell applauds the paper as a very useful first step on a topic that has received insufficient research.

Concluding Comments

In summary, then, this volume highlights the complicated nature of the relationships between equality and prosperity: they appear to compete in some areas, and complement each other in others. Seeking both requires judicious use of a few tools.

Inasmuch as the investigation here allows a prescription, it would appear that human capital investment, both encouraged by government subsidies and provided directly, is the principal means toward faster growth and a more equal distribution of resources, and that a progressive expenditure tax is the best means to finance this investment. Modest conclusions, perhaps, but actually implementing them represents a challenge. Just how private incentives can be better harnessed within the education sector — in ways that respect Canadians' concern for equality — and how tax reform can be moved along to actual legislation are issues requiring much work. Nevertheless, in such a complicated area, where the stakes are so high, even modest conclusions that lead to some basic guidelines should be a source of satisfaction and encouragement.