

Tax policy for equality and social mobility*

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1 Overview

Inequality of labour market outcomes is on the rise in many rich countries, Canada included. This matters because inequality has the potential to shape opportunity.

The starting point of this submission is the tendency for higher inequality to be associated with less mobility across generations, the adult labour market outcomes of children being more closely tied to their family background in more unequal countries. In other words, the greater the degree of inequality at a point in time, the greater the fraction of inequality that will be passed on to the next generation. This is associated with the idea that higher inequality of outcomes is associated with lower equality of opportunity.

Families play the central role in determining the life chances of their children. This reflects the time parents have with their children, and the quality of the environment to which their children are exposed. In this sense, children may benefit from having more educated parents, but they are also influenced more generally by the values, sense of motivation, and the overall family culture that parents foster. Non-monetary resources matter.

But parents also influence their children's development with monetary resources, which depends upon their engagement with the labour market. As such, the structure of the labour market, and the nature of jobs and pay matter for children. More polarized and more turbulent labour markets can cast a shadow on child development by influencing not just the wage rates parents command,

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but also the security of employment and incomes. Lower pay and more hours of work may mean less money and less time for children. Job loss may mean lower income and also changes in residence, schools, and networks of support.

Public policy also has a role to play in determining child development. Taxes and transfers can buffer families from labour market changes. In addition, child care and flexible work arrangements can support labour market participation and higher incomes. Public policy can also promote child development and social mobility through the provision of important sources of human capital, like schooling and health care. Generally, the more “progressive” the design of government programs—that is, the more advantage they are to the relatively less advantaged—the more likely they are to loosen the tie between socio-economic status and outcomes, and promote generational mobility. Public policy, however, could have just the opposite impact if it is of relatively more advantage to families that are relatively better off.

This submission focuses on those areas of public policy that fall within the jurisdiction of the federal government. It proposes policies that support families in their role as primary caregivers in a way that insures against inequalities in both monetary and non-monetary resources.

With respect to monetary resources these involve:

1. a significant increase in the Working Income Tax Benefit;
2. a reform of the Employment Insurance program that moves part of the program from an insurance program for job loss to an insurance program for wage loss;
3. the use of income-averaging over multiple years so that income taxation is more closely tied to actual life-time earnings rather than annual earnings;
4. tax reform at the upper end of the income distribution involving higher effective marginal tax rates.

With respect to non-monetary resources they involve:

1. support for care and education during the early years;
2. employment arrangements that offer flexibility for parents, including a reform of the Employment Insurance program that offers a parental leave program regardless of a child’s age.

2 Tax and Transfer policies

While labour markets, which determine wage rates and the returns to human capital, are the major source of incomes and possibilities, tax and transfer policies also clearly play a role in determining the level of inequality and the promotion of opportunity. They cannot play the central role, but are important not only as the source of revenues for social investments in health and education, but also as a form of income support and insurance.

The relatively high average degree of generational mobility for past generations of Canadians masks the fact that about one-third of children raised in the bottom quarter of the income distribution grew up to become adults who were in turn in the bottom quarter. But adequate income support needs also to be supplemented with sufficient insurance that smooths the variability of incomes, which in and of itself can have negative long term consequences for children. For example, youth raised in families in which the main breadwinner suffered a permanent layoff, and hence a drop in income, experienced almost 10% lower adult earnings than otherwise comparable children.

Policy makers need to accept that tax policy is an exercise in balancing trade-offs, the dimensions of which may vary with economic and labour market changes. A globalized labour market for the most talented, for example, puts a limit on the highest marginal taxes that can reasonably be imagined. But at the same time in an era of higher inequality policy makers are called to advance more adequate income support that complements labour market engagement, and that also offers more complete insurance in the face of labour market turbulence.

2.1 A significant increase in the Working Income Tax Benefit

A guaranteed annual income adequate for families and their children to participate normally in society, which I take to mean roughly about half of median income, should be a goal of income transfer policy. But this should be implemented in a way that is conditional on work, with the ideal structure reflected in the design of the Working Income Tax Benefit (WITB). In spite of being increased significantly in 2009 after its introduction in 2007, the WITB remains relatively modest, offering a maximum of just under \$1,700 to families with annual incomes in the neighbourhood of \$10,000 to \$15,000, falling at higher incomes, and phasing out entirely at not quite \$26,000. Policy makers should advance the idea of raising the level of benefits and reducing the rate at which they are phased out so that the WITB extends further into the range of lower-middle family incomes. They should also advance the idea of indexing this program to growth in per capita GDP, or some other suitable index.

2.2 A change from “Employment” Insurance to “Wage” Insurance

This could be done in conjunction with reform of the Employment Insurance program, changing part of it into wage insurance, particularly for longer tenure workers suffering permanent layoffs. This would in effect deliver benefits with a design inspired by the WITB, with the goal being to narrow the gap between the new wage and the original wage by appropriately topping up income.

The distinction between insuring a job and insuring wages is inconsequential if most jobs are alike in the skills they require and how much they pay. This may have been the case when unemployment insurance was originally conceived

in the 1940s, but it is less true today, in an economy requiring workers to find re-employment in different sectors with different—likely lower—wage rates.

The distinction between unemployment insurance and wage insurance is particularly pertinent for workers who had jobs in those parts of the traditional manufacturing or service sectors that paid above average wages, and who face permanent displacement and wage loss. In this sense the risk to be insured is not so much the loss of a job, covering the time it takes to find a new job, but the loss of a wage, covering the drop in wage rates. These workers, given their human capital and location, may have to make a transition to new service sector jobs, or jobs in other locations, that are likely to pay much lower wage rates.

An insurance program that insures the unemployment associated with job loss implicitly encourages laid off workers to resist accepting jobs in lower paying sectors, maintaining the hope they will be able to return to or find jobs suited to their human capital. An insurance program that offers benefits according to a percentage of the wage loss they suffer in accepting jobs in other sectors will encourage rather than retard the shift in employment to new sectors.

2.3 Income-averaging for tax purposes

Policy makers should advance a form of wage insurance, but also tax reforms that permit individuals to average their earnings over a period of several years so that one year of very high or very low-income does not have important tax implications. A scheme of averaging will focus the tax system on overall life-time income, rather than on annual income that could fluctuate significantly from year to year. If life-time earnings fall because of a permanent layoff, then some of the taxes paid in previous years would be rebated.

Together these three forms of income smoothing, WITB at the lower end of the wage distribution, wage insurance at the lower middle and middle parts, and income averaging at the middle and upper-middle section of the distribution would offer a more constant flow of income. There is more volatility in incomes in a globalized high-tech economy, and the tax system should be designed to recognize this and buffer families and children.

2.4 Higher effective marginal tax rates at the top

The possibility of income averaging should be advanced in the context of increasing the progressive nature of the tax system, recognizing not only that those with substantial incomes are capable of self-insuring, but also that higher top shares imply an increased ability to pay.

Economists judge the functioning of the tax system in a number of ways: certainly the system should not be administratively cumbersome, and it should treat equals equally. But just as importantly it should not, to the greatest degree possible, introduce inefficiencies by causing individuals in a well-functioning market to change their behaviour. Finally, the tax system should raise more revenue where it will cause the least pain. The general presumption is that losing a dollar when you already have many causes less pain than when you

have only a few. This principle of equal marginal sacrifice suggests that tax rates should be progressive: as income increases, the greater the fraction that should be paid in taxes. All other things constant, rising top income shares call for higher top tax rates.

But all other things are usually not constant. The most obvious way to make the tax system more progressive is to introduce a higher tax bracket for top earners. Currently every dollar of earned income above \$135,054 is taxed at the top federal rate of 29%. To make it into the top 1% in 2010 required an income of \$215,800, well above the threshold for the top federal tax rate to kick in. The potential downside is that a higher tax rate on the income earned above some higher threshold may lead top earners to work less, a reduction in their labour supply implying an efficiency cost. It is not clear how strong this disincentive would be. Economic research probably knows less about the responsiveness of labour supply to tax changes among high earners than it should, even if economic theory actually predicts that a higher tax rate may increase, not decrease, work effort. Either way this behavioural change is unlikely to be significant.

The more relevant labour supply decision concerns the possibility of encouraging a brain drain, and in part this is what put a limit on higher marginal tax rates during the mid 1990s. In some measure top earners in Canada owe their high incomes to a spillover from the US through the North American, or indeed global, labour market to which they belong. However, the downside of inducing a brain drain is probably not as great now as it was then, in part because of the economic downturn has dampened the growth in US top shares (though that is already changing), but mostly because top marginal tax rates have been increased in the United States. If there was an acceptable balance between Canadian and American tax rates before the recent changes by the Obama administration, then there is at least some scope to reassert the relativities by raising Canadian top rates. Some economists have pointed out that a combined federal-provincial top marginal rate of 50% would not be out of line.

But changes in behaviour are not limited to labour supply decisions. It remains an open question if higher marginal tax rates would raise significant revenues even if there were no changes in labour supply because of tax planning that shifts the composition of income to lower taxed sources. Any call for higher statutory marginal tax rates at the top must go hand-in-hand with reforms to the tax base that move in the direction of taxing income at the same rate regardless of its source.

This also calls for tax policy to focus more on income sources that do not induce behavioural change, and certainly to remove subsidies to the most well off. Higher taxation of incomes associated with “rents” would in principle not lead to any behavioural changes, the appropriate taxation of income from natural resource exploitation being a prime example.

The fact that top shares have risen significantly and that those in the top are likely to stay in the top also raises the possibility that the distribution of wealth will become more unequal, and progressive tax reforms would, from this perspective, call for an inheritance tax to apply above some suitably defined minimum amount. If inheritances are not taxed, then a tax on all capital income,

perhaps at a lower rate than earnings, should be included in the tax base. This involves taxing the capital gains from the sale of a principal residence, again only above some threshold. The exclusion of capital gains from the principal residence is a significant tax subsidy to all tax payers, but it benefits those at the top much more than the bottom. This subsidy introduces a market distortion, and is regressive in a distributional sense.

Policy makers should also retreat from the outdated way in which unemployment insurance is financed. By not reflecting actuarial principles the funding of this program offers a persistent subsidy to firms who are more inclined to temporarily layoff and recall workers. Tying the contribution rates of firms to their lay-off history may prove administratively cumbersome, though there are examples of some programs that have an element of experience rating. It may be more effective and less cumbersome to develop a series of personal accounts in the unemployment insurance system in which the contribution rates of individual workers are linked to the balance between their past contributions and benefit receipt.

At the same time the maximum insurable earnings should rise. To some extent this will ease the regressive nature of this payroll tax by requiring higher earning individuals to contribute more. The retreat from inefficiencies embodied in the unemployment insurance system has been a persistent reduction of benefits, without regard to the financing of the program. The erosion of benefits should be halted and perhaps even reversed, and the move to an actuarially fair system should involve reforms to contributions. A proposal to make a component of Employment Insurance a “wage” insurance program should go hand-in-hand with funding that is based upon individual accounts.

3 Family policy and time stress

The long-run attainments of children are determined not only by the monetary resources parents have to care for them and invest in their future, but also a whole host of non-monetary resources. These range from the amount of time parents have to spend with their children, the attitudes to schooling and work that they pass on, as well as the networks that allow parents to access community resources or otherwise promote their children’s welfare from the early years right through the teen and young adult years, as they make the transition from school to work.

In more polarized and unequal labour markets parents are working longer hours, and struggling more intensely to balance work and family life. If there is a general call that the labour market should be the prime source of income, and if labour market and tax-transfer policies are increasingly geared to encouraging labour force participation—through for example the WITB—then there is also a clear need for public policy to address the trade-offs this may imply with respect to the needs of children. These relate not just to money, but also to a positive and nurturing environment.

3.1 Support for care and education during the early years

Policy makers are called to accept the importance of the early years in setting children down a path of successful development and growth, and to accept the prime role that families play in this process. They are called to accept the fact that the returns to investments in the early years are higher than at any other point in the life cycle, and to continue to support effective early years programs.

How exactly to make early years investments is an open issue, but early years policy, and indeed family policy in general, needs to offer flexibility of choice. And while the early years matter, they need to be complemented with continued investments throughout a child's life. Policy makers should advance employment arrangements that give parents the flexibility to balance work with family life. The introduction of parental leave through the Employment Insurance program to care for newborn children is an important example that should be built upon. The birth of a child can be a stressful and challenging period in family life, and offering working parents the opportunity to receive income support during a period of leave from work that is almost one year in length has proved important in reducing time stress and putting the needs of children first.

3.2 Employment Insurance that offers parental leave regardless of a child's age

But children may require focused attention of this sort throughout their lives, and the Employment Insurance program should have a more general and flexible system of leave at all stages of family life. Families increasingly face demographic risks associated with marital disruption, child illness, the onset of disabilities, or other non-market events. Offering a generalized benefit stream in Employment Insurance to address these risks would address the continually evolving need to balance labour market engagement with non-market responsibilities.

This benefit structure could be designed to have higher maximum insurable earnings so that a broad swath of mid-career, mid-income earners are more fully covered. In some measure this should also be based on personalized accounts from which families could draw depending upon the extent of their surplus. Lower income households could be given more of a public subsidy within these accounts, but all families would have the flexibility to use their surplus to support a leave from work according to their own timing and purpose. In effect, the Employment Insurance program would be used to finance leaves from employment for whatever concern the individual deems to be important, allowing families not just to smooth income through periods of unemployment in the traditional sense, but also to smooth time through periods of intensive parental responsibility.

Sources

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That inequality is on the rise in many rich countries, including Canada, is thoroughly documented in OECD (2011), *Divided We Stand: Why Inequality Keeps Rising*, Paris: Organization for Economic Cooperation and Development. I offer more Canadian specific details in section 3 of Miles Corak (2013), “Public policies for equality and social mobility in Canada,” Ottawa: Canada2020, available at <http://canada2020.ca/wp-content/uploads/2013/02/Canada-2020-Background-paper-Public-policies-for-equality-and-mobility-in-Canada.pdf>.

The idea that inequality shapes opportunity is an inference drawn from the so-called “Great Gatsby Curve”. This is a term first used by Alan Krueger in a speech, “The Rise and Consequences of Inequality,” made at the Center for American Progress in Washington DC on January 12th, 2012. It also appears in The Economic Report of the President for 2012, and is presented as Figure 1 in Corak (2013). The details are discussed by Miles Corak (2012), “How to Slide Down the Great Gatsby Curve,” Washington DC: Center for American Progress, available at <http://www.americanprogress.org/issues/economy/report/2012/12/05/46851/how-to-slide-down-the-great-gatsby-curve/>. This paper also discusses the underlying causes, particularly the interacting roles of family, labour markets, and public policy in determining the degree of generational mobility and the differences between countries, and documents the fact that Canada is a relatively mobile country intergenerationally.

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The source for the claim that adult incomes are lower for children raised in families with fathers experiencing a permanent layoff is Philip Oreopoulos, Marianne Page, and Ann Huff Stevens (2008), “The Intergenerational Effects of Worker Displacement,” *Journal of Labor Economics*, Vol. 26 no. 3, pages 455-500.

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The discussion of rents, resource taxation, income averaging and also parts of the discussion of tax reform dealing with inheritance and capital gains taxation as well as the inherent trade-offs in the design of tax policy is informed by the much more detailed discussions in OECD (2011), and for the Canadian context by Robin Boadway (2011), “Rethinking Tax-Transfer Policy for 21st Century Canada,” in Fred Gorbet and Andrew Sharpe (editors), *New Directions for Intelligent Government in Canada: Papers in Honour of Ian Stewart*, Ottawa: Center for the Study of Living Standards, available at <http://www.csls.ca/festschrift/Boadway.pdf>.

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Canada Revenue Agency web site at <http://www.cra-arc.gc.ca/tx/ndvdl/fq/txrts-eng.html> and the threshold to be in the top 1% is from Statistics Canada CAN-SIM table 204-0001.

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The discussion of actuarial fairness and the use of personalized accounts in the unemployment insurance program is from Miles Corak (2012), "The Unemployment Insurance We Want," University of Ottawa, unpublished. Alice Nakamura (1996), "Employment Insurance: A Framework for Real Reform," Toronto: CD Howe Institute also discusses this design.