

BUILDING A BETTER FUTURE

BÂTIR UN AVENIR MEILLEUR

WHEN Canadians go to the polls later this year, many of them will be making their choice based on their impression of who can best manage persistent economic uncertainty. Others will be concerned about caring for older loved ones or having the means to adequately provide for their family. Others still will be assessing each party's response to global terrorism and domestic radicalization.

To help inform voters' choices, *Policy Options* asked leading researchers and practitioners in diverse fields to identify a pressing policy issue that should be a priority in the election and to make the case for how decision-makers can best address it. While it certainly is not an exhaustive list, taken together, their responses provide a compelling agenda for public debate that all political leaders should consider.

EN se rendant aux urnes plus tard cette année, beaucoup de Canadiens donneront leur voix au parti qui leur semble le mieux apte à gérer l'incertitude économique persistante. D'autres seront préoccupés davantage par les soins à prodiguer à leurs aînés ou les moyens de subvenir aux besoins de leur famille. D'autres encore évalueront les mesures préconisées pour lutter contre le terrorisme international et la radicalisation des jeunes d'ici.

Pour éclairer le choix des électeurs, *Options politiques* a demandé à des chercheurs et des spécialistes reconnus de déterminer quel enjeu clé il faudrait mettre au cœur de la campagne, et comment nos décideurs peuvent s'attaquer à cette priorité. Sans former une liste exhaustive, leurs réponses composent un solide programme qui enrichit le débat public et devrait inspirer tous nos dirigeants.

WHY THE INCREASE IN INEQUALITY MATTERS

LARS OSBERG

Growing income inequality is not just a serious economic challenge. Left unaddressed, it could also have a significant negative impact on Canada's political fabric.

Les inégalités de revenu croissantes ne sont pas qu'un défi économique. Si on n'y remédie pas, elles pourraient sérieusement menacer le tissu social et politique du Canada.



The new normal in Canada and the United States over the last 30 years is that incomes at the top have grown rapidly while middle-class incomes have stagnated. As a consequence, the real-dollar income gap between the top 1 percent of taxpayers and the median household in Canada doubled between 1982 and 2010 and, if historic trends continue, will more than double again by 2032. Why does this matter?

To some extent, the top 1 percent already consume their incomes in a separate world of exclusive shops and expensive neighbourhoods, one where most of the other 99 percent never go. The increasing magnitude of top 1 percent consumer expenditures has sustained a growing infrastructure of inequality (for example, high-end shops, five-star resorts, luxury car dealerships), and over time the growing top-end market will mean that ever more entrepreneurial energy is devoted to the design, production and marketing of such separate spheres of exclusivity. Strong income growth for the top 1 percent implies that, as their incomes diverge increasingly from the median, they experience an increasing disconnect from the lived reality of everyone else. But so what? Why should anyone care if the top 1 percent pull steadily away from the middle class?

ONE reason for concern about increasing income gaps is inequality of opportunity. The data are very clear: coun-

tries with more income inequality have more inequality of opportunity. Economists have long recognized that in a market economy, more income inequality for adults inevitably produces more inequality of opportunity for children, because the increasing incomes of top 1 percent parents enable them to purchase ever more influence over the social mobility process.

As Alfred Marshall remarked in *The Principles of Economics* over a century ago, "The professional classes especially, while generally eager to save some capital for their children, are even more on the alert for opportunities of investing it in them," while the children of the working classes "go to their graves with undeveloped abilities and faculties." Marshall insisted that "this evil is cumulative."

Greater inequality raises the stakes in childhood educational achievement. As some parents respond by increasing the pressure on their children, the resulting "loss of childhood" is one of the costs of increasing income inequality. However, individual effort only partly determines success. Canada's widening income gap also implies that top 1 percent parents have increasingly more income to spend on private schooling, better school districts and greater enrichment activities to enhance their own children's chances of success.

In addition, top slots are limited and real life is competitive — when some people get ahead in social rank, others necessarily fall behind. But those who are already at the top can only lose from future mobility. For the top 1 percent, the only future mobility is downward. Hence, the dark side of increasing inequality is that affluent parents have increasingly more to lose from improvements in the

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life chances of their children's competitors. The greater the gap between the incomes of affluent families and those of everyone else, the steeper is the "drop from the top" and the more important it becomes for rich parents to ensure their own children have every possible advantage.

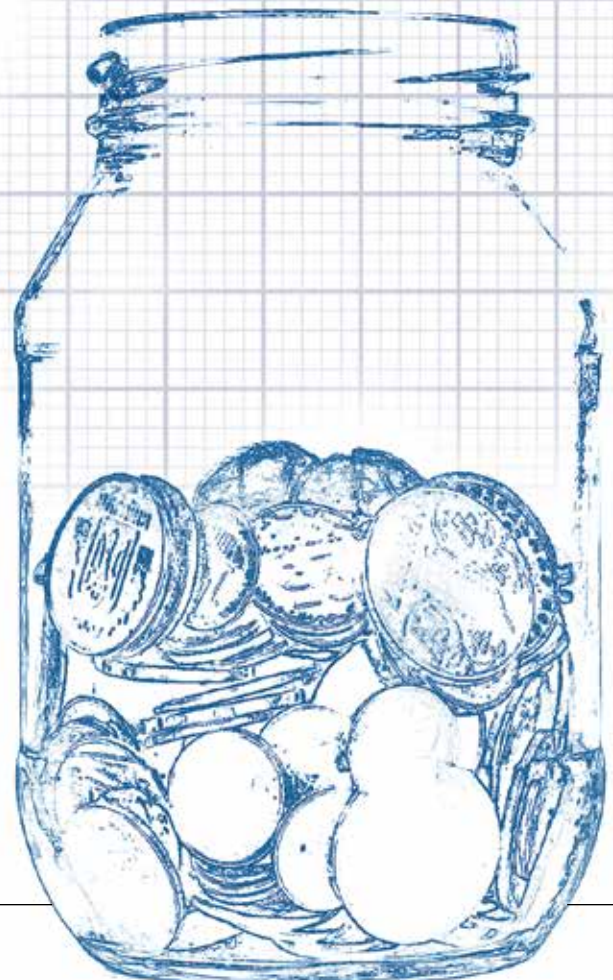
The rhetoric of fair equality of opportunity enjoys near universal approval among Canada's economic elite — partly because it legitimizes their own position. However, making equal opportunity a reality takes money. Over time, as the top end pulls further and further away from middle-class living standards, the stakes involved in preventing downward mobility of their own children are ever-increasing for the top 1 percent. Increasing inequality thus accentuates the reluctance of the elite to pay the taxes that could fund public spending on the human capital of all children and thereby lessen inequalities of opportunity — because their own children have, potentially, the most to lose from fair competition.

As well, when incomes at the top grow more rapidly than other incomes and income gaps widen, luxury goods grow

as a fraction of total consumer spending and norms of luxury escalate. Luxury goods are advertising-intensive items which appeal to ideas of exclusivity and status to motivate sales. The large and increasing relative size of the top-end market is a powerful incentive for an ever-increasing volume of aspirational advertising, and it is not in an advertiser's interest to restrict its messaging to only those who could actually afford to buy.

Status goods (like expensive watches costing thousands of dollars) can command a premium price only if they are widely known to be status goods — there is no point in paying thousands more for a fancy watch if nobody else is going to recognize it as special. Hence, advertisers have to market luxury goods, like expensive watches, both to those who cannot afford to buy as well as to those who can, in order for those who do buy them to know that everyone else knows that these are very expensive, very exclusive items.

As income gaps widen, the expanding pool of disposable income among the very affluent creates ever greater incentives to create new status goods using advertising.



Aspirational advertising creates desire (and sales) in the target audience by creating discontent. In such marketing campaigns, the message is that “everybody wants this, but only special people have it” — that is, desire is created by inspiring discontent and envy among those who do not possess the good, so that those who do buy it can have status and deference. Because the market value of luxury brands will depreciate without continued advertising to reinforce their message of exclusivity, privilege and wealth, mass media become increasingly saturated with such messaging.

As income differentials grow, the benchmarks of luxury move ever further away from the consumption norms of middle-class households, and the volume of luxury goods advertising increases — thereby ensuring that the less affluent are told increasingly more often about the pleasures of goods they cannot remotely afford. Increasing inequality in a market economy therefore increases the incentives for advertising expenditures that increase discontent and envy.

For the 99 percent, an externality of rising top 1 percent incomes thus is the increasing volume and changing messaging of their daily bombardment of advertising. As advertising

increases and is increasingly tilted toward emphasizing the importance and desirability of goods that most people cannot possibly afford, less human happiness is one likely outcome.

ANOTHER likely outcome is greater consumer debt. Even when middle-class incomes stagnate (between 1984 and 2011, median real household income in Canada grew by only 0.35 percent annually; in the United States, it grew even less, at 0.28 percent annually), people who are willing to go into debt can still try to keep up with escalating consumption norms. If financial institutions are also willing to intermediate, as they were in the US prior to the 2008 financial crisis, the desire of lower-income households for credit can be matched with the increasing amounts of savings that the growing incomes of the top 1 percent of households make available to lend.

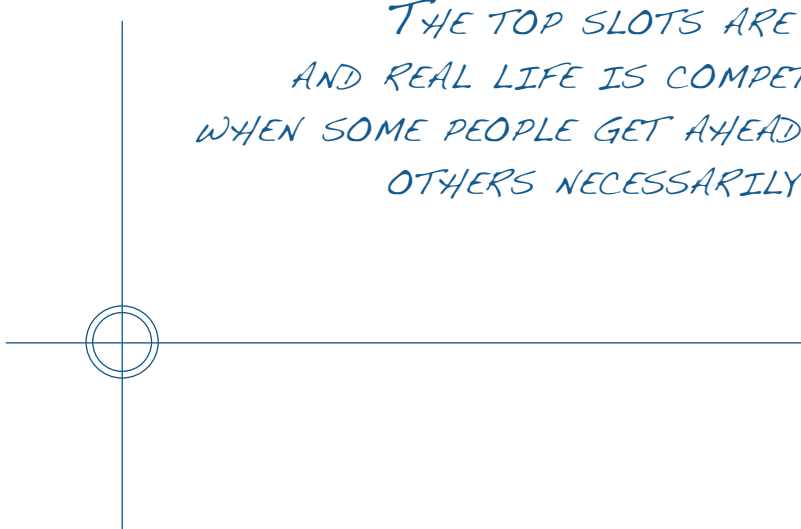
In the actual historical context of the United States, before 2008, the matching of willing borrowers and willing lenders was greatly facilitated by higher housing prices (which allowed households to support consumption through mortgage refinancing), financial innovation (which allowed banks to repackage these loans and sell them as financial assets) and a facilitative regulatory environment. This combination of institutional context, willing borrowers and willing lenders successfully maintained high aggregate demand and relatively low unemployment. Nevertheless, the continued stagnation in the incomes of poor and middle-income households meant that loans and leverage kept rising, implying a growing probability of a major crisis with severe implications for the real economy — which eventually did occur.

When incomes grow rapidly at the top, the increasing incomes of the top 1 percent imply both ever greater consumption and an increasing flow of their savings into financial markets. But financial instruments are inherently both an asset to the holder and a liability to the issuer. In order for the increasingly affluent to acquire ever more financial assets, somebody else has to acquire ever more financial liabilities. Indeed, macroeconomic balance requires it. If aggregate expenditure is to equal aggregate income, whenever the increasingly affluent abstain from spending some of their increase in income, some other agent has to spend more than their income.

Borrowing and spending by debtors — households and governments — can balance the real flows of the economy at full employment output, but this comes at the cost of simultaneously increasing the stock of debt. If borrowing and spending are insufficient, at a given real rate of interest, to maintain high levels of economic activity, downward pressure on aggregate output and real interest rates is the result. Had the aggregate demand created by the debt-fuelled US consumer and housing boom of the early 2000s not been present, debt instability and financial crisis could perhaps have been avoided, but at the cost of slower growth and less employment.



SHUTTERSTOCK



*THE TOP SLOTS ARE LIMITED
AND REAL LIFE IS COMPETITIVE —
WHEN SOME PEOPLE GET AHEAD IN SOCIAL RANK,
OTHERS NECESSARILY FALL BEHIND.*

WHEN top incomes grow rapidly and middle-class incomes stagnate, the resulting imbalance in income growth thus produces unpleasant choices for macroeconomic policy-makers: either to stimulate consumer borrowing and aggregate demand (with the implication of rising household debt-to-income ratios, now at a historic high of 163 percent in Canada) or to tolerate the slower growth and higher unemployment that results when firms, governments and households all try to restrain their spending simultaneously. It is in this context that there are serious fears, in the aftermath of the financial crisis, that the unpalatable alternatives — for both North America and Europe — may well be to choose debt-fuelled growth and systemic instability or to accept a structural tendency to secular stagnation.

In principle, increasing inequality in the distribution of pretax market income and rising government deficits and debt could both be addressed by higher taxes. Specifically, by reversing the trend to lower top-end income tax rates that has actually occurred in Canada and elsewhere, Canadian governments could decrease inequality in disposable income and reduce the national debt. But although the bottom 99 percent may want to try to ignore the top 1 percent, the top 1 percent do not want to be ignored, either politically or socially — and particularly not when it comes to taxes. Increasing inequality means they have ever more resources to intervene in the political process and to ensure that their opinions matter to others.

In the United States there is clear evidence that:

- the political and social preferences of the very affluent are quite different from those of the general population;
- the top 1 percent are much more active politically than the 99 percent;
- election campaigns depend heavily on major financial donors, who are overwhelmingly affluent individuals; and
- legislative action is heavily influenced by the policy priorities of the very affluent.

UP to now, Canada has, unlike the United States, been able to impose constraints on campaign spending in elections. But spending between elections to influence the climate of opinion for elections — by parties and by ostensibly public-interest shell foundations — is unconstrained. And the termination of public funding for political parties makes them ever more dependent on private donations.

In general, as the lived reality of Canada's top 1 percent increasingly diverges from everyone else's, the cost of their growing influence over the political process steadily diminishes the effective democracy available to the rest of society. But the specific issue of taxation is particularly important.

Canada's increasing inequality today is the direct result of roughly 30 years of unbalanced growth. If the elite are unwilling to accept the higher marginal income tax rates that could stabilize inequality, the continuation of past trends will produce ever-widening gaps in disposable income, growing inequality of opportunity and continued unpalatable choices between short-term growth and systemic stability. ■