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#1 IN A SERIES

FROM A MANDATE FOR CHANGE TO A PLAN TO GOVERN

Creating Economic Opportunity for the Middle Class

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INTRODUCTION

The new Liberal government has put Canadian middle income earners at the centre of its agenda. Its election platform was called *A New Plan for a Strong Middle Class*, and its initial steps as the government reinforced this preoccupation. Each ministerial mandate letter refers to Canada's "struggling middle class" and the letter to the new Minister of Finance emphasizes the Prime Minister's conception of "inclusive growth."

The government's concern for Canada's middle class seems sincere and should be lauded. Canada is stronger when incomes are broadly growing and it is right for the government to have social mobility as one of its top policy objectives.

The Macdonald-Laurier Institute's mission is to help to inform sound public policy at the federal level. Our goal in this essay series is to help the new government best achieve its top policy objectives.

This first essay in the series will help Canadians better understand exactly what the circumstances of Canada's middle class are and the exact extent to which it can be said to be "struggling." The purpose is to ensure that

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our public policy debate is rooted in empirical evidence and not data and experience from the US context, which is often quite different from our own. We need to avoid Canadian policy based on American evidence.

We will then offer what we think the Canadian and international evidence establishes as the best policy options to help to secure a “strong and growing middle class.” These policy options will be further developed in subsequent essays.

INCOME INEQUALITY VERSUS SOCIAL MOBILITY

Concerns about a perception of income inequality have been an animating issue in Canada’s policy discourse for several years. According to the Canadian Centre for Policy Alternatives, wealth and income inequality are “on the rise” (2013) and “one of the biggest challenges of our time” (2015).

These perceptions of a stagnant middle class and a growing disparity between wealthy Canadians and the rest of the citizenry are a major part of the new government’s agenda in general and its focus on bolstering the country’s middle class in particular.

While these claims seem to have considerable political cachet, the so-called “growing gap” is not to be found in the Canadian statistics. The risk is thus that our policy debate imports data and the experience from the United States – where such a gap *does* exist – and is focused on policies to counteract a trend that is not pertinent, or at the very least less pronounced, in Canada.

The federal government creates many of the most important conditions for social mobility – that is, the circumstances for individuals to climb the socio-economic ladder. Robust social mobility is one of the empirical measures of a society’s economic and social vitality. And the new government ought to be credited for its focus on inclusive economic growth.

But a recurring theme of the Liberals’ election campaign was the need for public policy to be soundly rooted in the available evidence. Policies in pursuit of an inclusive growth agenda should be no exception. The government needs to ensure that it has a good understanding of the current state-of-play here in Canada before determining what policy actions should be undertaken to bolster economic opportunity and middle-class wage growth.

As one Macdonald-Laurier Institute *Commentary* puts it: “Inequality is terribly complicated and simplistic diagnoses risk worsening the problem” (Clemens 2011). This risk is exacerbated by the already-noted tendency to conflate the Canadian experience with that of the United States. It is incumbent on the new government – which has frequently cited the perceived inequality gap as a motivating issue – to understand these nuances before setting a policy course for the future.

The measurement of income inequality is fraught with challenges. These limitations can leave policy-makers with an incomplete picture of the socio-economic landscape.

One measurement challenge is the tendency to overlook the equalizing effect of the tax and transfer systems. One of the principal aims of the tax and transfer systems is to provide for redistribution among income groups. A recent study published by the Macdonald-Laurier Institute finds that the transfer system has a “substantial impact on the distribution of total incomes” (Cross 2015). In particular, it finds that the net effect of the tax and transfer systems is to boost low incomes by 50.6 percent and reduce the highest incomes by 19.1 percent. This evidence that Canada’s current system is highly progressive must be part of any discussions

about income inequality and what, if any, further steps should be taken to counteract the perceived gap.

Another major challenge is the tendency to rely on a snapshot of income and wealth distribution and, in so doing, fail to account for changes over an individual's life. This methodology provides a stationary window into an individual's earnings and wealth accumulation. The problem is that this static analysis fails to account for social or economic dynamism and the extent to which individuals' economic circumstances change markedly over time (Lammam and Speer 2014).

A 2012 study, which used Statistics Canada data to track a sample of a million Canadians to see how their income changed over time, found clear evidence of social mobility over the lifecycle (Lammam, Karabegovic, and Veldhuis). The study put individual tax filers into five income groups from lowest to highest income, with each group representing 20 percent of the total. In 1990, the lowest 20 percent of income earners had an average income of \$6000 (2009 dollars). By 2009, the last year for which the study produced data, 87 percent of those in the bottom income group had moved to a higher group and their average income climbed by 635 percent to \$44,100. Put differently, almost nine of ten Canadians who started in the bottom 20 percent had moved out of low income over this 20-year period.

And the upward climb was matched by a shift downward by some. Among those initially in the highest income group in 1990, 36 percent moved to a lower income group by 2009. The average income of those originally in the highest 20 percent of income earners in 1990 increased by only 23 percent from \$77,200 to \$94,900 by 2009.

This degree of socio-economic dynamism is a reflection of Canada's culture of equality of opportunity. Consider, for instance, that the new government has a Cabinet minister who moved here from Afghanistan as a refugee less than 20 years ago. It is a phenomenon that ought to be celebrated. The story is even more pronounced when one considers our experience relative to that of the United States.

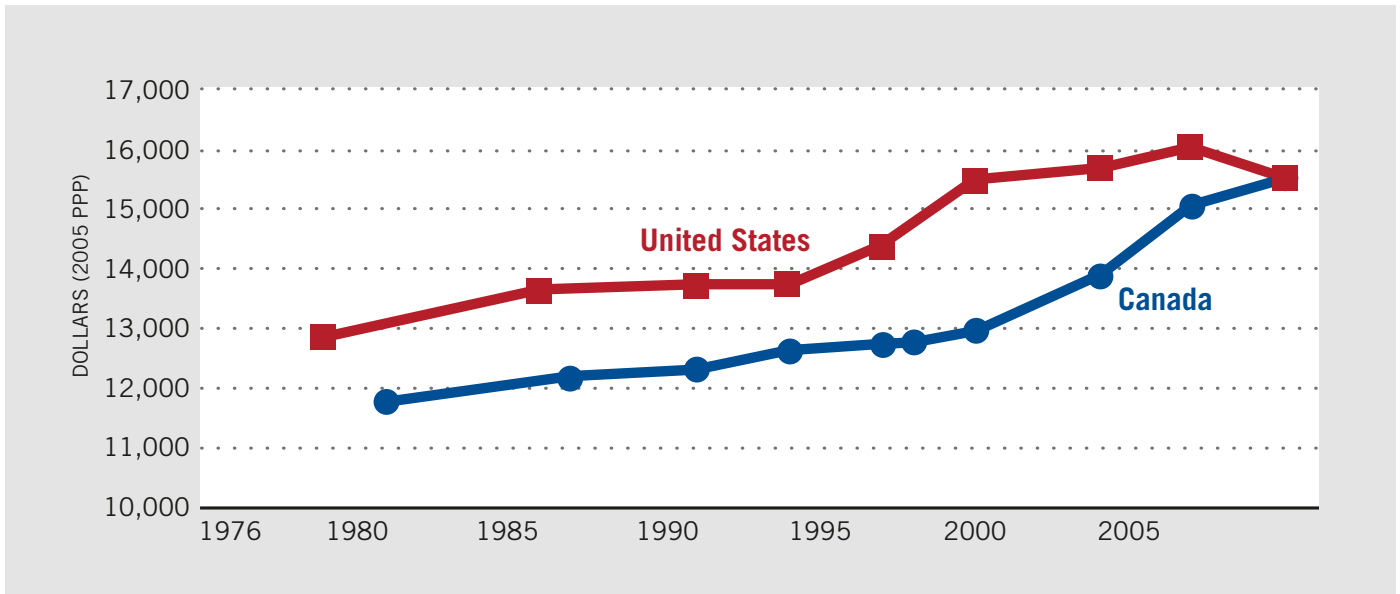
CANADA VERSUS THE UNITED STATES

A major source of confusion with respect to perceptions of income stagnation in Canada is the incomparable experience of the United States. Canada has exhibited much higher levels of social mobility and middle-class wage growth in recent years. Yet there is a tendency to draw conclusions based on the negative US experience. As one prominent think-tank scholar has put it: "the dismal U.S. headlines do not reflect Canadian reality" (Yakabuski 2013).

A 2014 *New York Times* project sought to measure middle-class income growth among industrialized nations over a 30-year period from 1980 to 2010 (Leonhart and Quealy 2014). Its findings were illuminating. At the outset, the American middle class (defined as families earning between \$35,000 and \$100,000 a year) had higher incomes than their counterparts almost anywhere in the world. But low- and middle-income earners in the US experienced slower income growth over the ensuing period relative to those in other advanced economies and the size of its middle class shrank by about two percentage points.

The data show a different experience in Canada. While median income per capita was virtually unchanged in the United States from 2000 to 2010, it rose 19.7 percent in Canada over this period. In fact, by 2010, Canada's median income matched that of the United States and, since then, other data suggest that Canada has moved ahead. The size of Canada's middle class (using the *New York Times* definition) stayed remarkably constant over this period at roughly 43 percent of households.

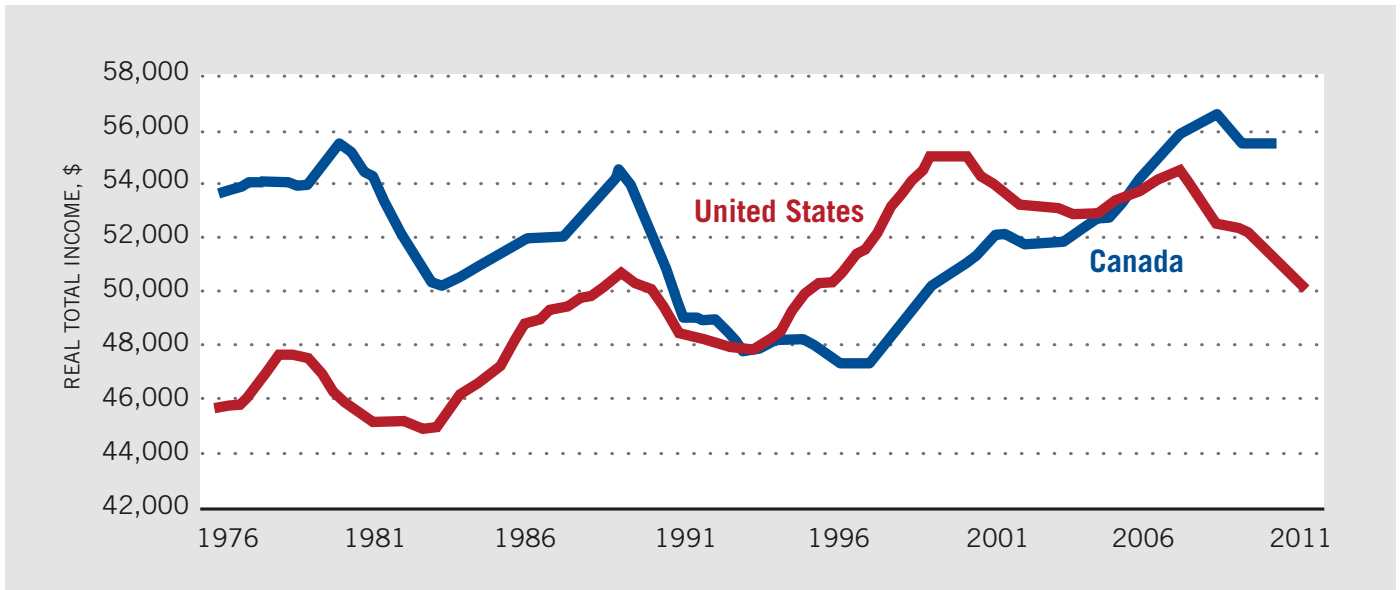
FIGURE 1: Median per capita income in Canada and the United States, 1979 to 2010



Sources: New York Times/Luxembourg Income Study analysis, April 22, 2014; Reeves and Rodrigue 2014.

A separate study comparing Canada and the United States, published in 2012, examined middle-class household incomes in the two countries dating back to the mid-1970s and found what the authors called “a tale of two countries” (TD Economics). Canada’s median household income lagged the United States for the most of the past 20 years. The gap reached its peak in 1998, when median household income in the United States was 10 percent higher than in Canada. But thereafter middle-class incomes stagnated in the US, while they experienced a solid pace of growth here. The result is that not only has Canada erased the 20-year gap, it created a 9-percent income advantage by 2010.

FIGURE 2: Median total household income in Canada and the United States, 1976 to 2010

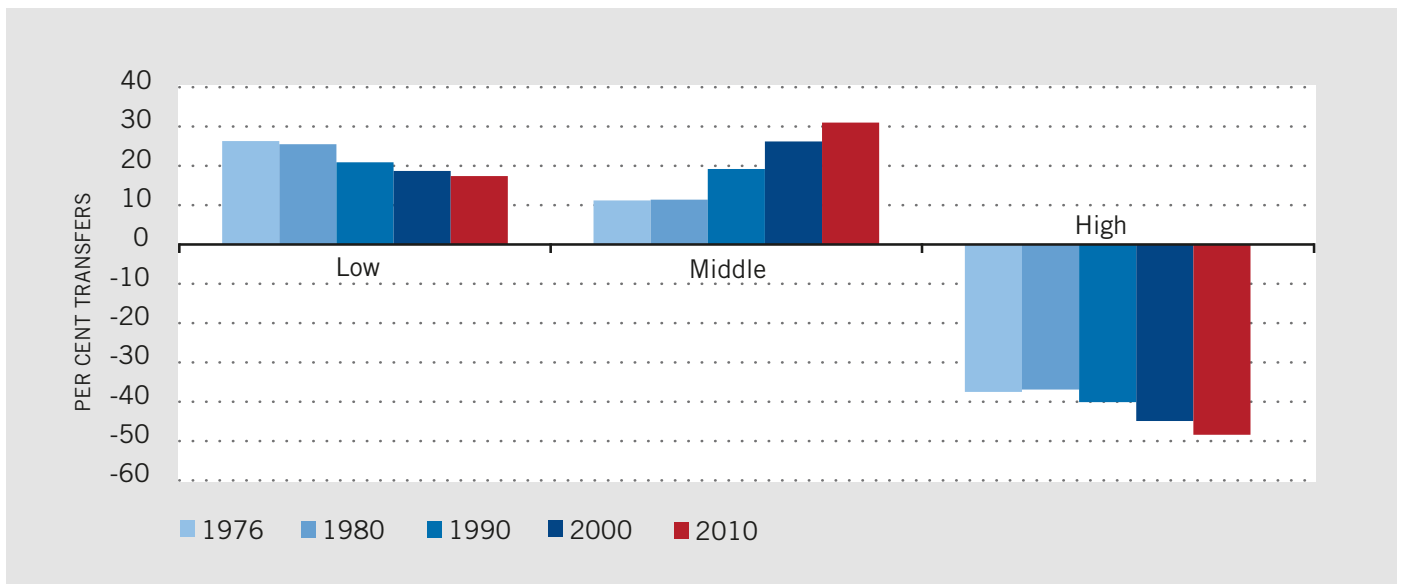


Source: TD Economics 2012.

The general trend line relative to the United States continues to look positive. Recent analysis by University of Laval economist Stephen Gordon (2015) shows that Canadian real wages are growing faster than in the United States. And this recent experience is hardly new. Real wages for Canadian workers have been growing faster than those of US workers for more than 10 years. Indeed, since the mid-1990s, Canadian workers have experienced rising wages broadly aligned with productivity growth in large part due to persistent labour demand (TD Economics 2012). Strong labour demand is bound to remain a reality and should serve as a driver of household income growth in Canada.

A study by two former Statistics Canada economists largely reinforces this assessment of Canada’s middle-class health (Cross and Sheikh 2015). The study finds that most middle-class outcomes continue to improve in absolute terms. To the extent that there is a policy issue, it relates to a low-skilled subsection of the middle class the paper’s authors refer to as the “working class.” They argue that a broad concern for the middle class is unjustified and may risk diverting government resources from better targeting them to low-income families. Figure 3 below illustrates this problem, showing transfers to the bottom 20 percent falling while transfers to middle incomes have risen in recent decades (Sheikh 2015).

FIGURE 3: Net transfers by income class (percent)



Source: Statistics Canada, CANSIM, 202-0704 (Sheikh 2015).

Note: “Low” is the lowest quintile, “high” is the highest quintile, and “middle” is the sum of the middle three quintiles. Transfers include all transfers by all levels of government. Tax includes income tax by all levels of government.

Overall, then, Canada’s experience with middle-class wage growth ought to be seen as generally positive. As columnist Andrew Coyne (2014) puts it:

Not only are Canadian middle class incomes among the highest in the world, but so is their rate of growth: up 20%, after, inflation, in the decade after 2000, allowing us to catch and pass first Germany and now the United States. This isn’t just a story of an American decline, in other words. It is a story of Canadian success.

Yet, despite Canada’s divergent experience, political commentary from the United States has come to colour our policy debate and created a false – or at least incomplete – picture of the state of the Canadian middle class.

THE STATE OF CANADA'S MIDDLE CLASS

Notwithstanding public perceptions and campaign rhetoric, the data show strong evidence of social mobility and middle-class income growth relative to the United States. These are developments of which Canadians ought to be proud. Canada has long been a refuge for those seeking economic opportunity. A social mobility agenda was at the heart of the Macdonald-Laurier policy consensus to which we have dedicated ourselves.

Wilfrid Laurier, Canada's first great Liberal Prime Minister, was a real champion of social mobility. His policy programme was preoccupied with creating the conditions for economic opportunity and social dynamism. It was reflected in his commitment to a low-tax, competitive economic environment, his liberalized immigration policy to attract newcomers and settle the West, and his support for transport infrastructure to promote economic development. If the twentieth century was to "be filled by Canada", as he famously said in 1904, it was to be based on inclusive growth. His intellectual legacy provides useful guidance for the new government.

And the upshot of the data is that the new government inherits an economy in which social mobility and middle-class wages are generally moving in the right direction. The fact is that Canada's middle class has never been as well off in our history. Using any yardstick – including median incomes, real wages, or household net worth – the evidence finds that Canada's middle class is experiencing income growth and wealth accumulation.

The question, then, for the new government is how to *avoid* the worrying trend in the United States and to ensure that Canada continues to exhibit middle-class wage growth in particular and inclusive economic growth in general.

POLICY RECOMMENDATIONS TO BOLSTER INCLUSIVE GROWTH

While the data show that concerns about Canada's middle class are overstated, the goal of growing middle-class incomes is still a worthwhile objective. Rising living standards for all Canadians ought to be among any new government's top priorities just as it was for Laurier.

A policy agenda to achieve this objective ought to focus on encouraging more opportunity and social mobility and greater overall wealth rather than equalizing outcomes through more redistribution. That is, the goal should be to help low- and middle-income earners climb the socio-economic ladder instead of bringing high-income Canadians down a few pegs. Such an agenda would represent a true vision of inclusive growth.

The new government has put forward several policy proposals to help achieve this objective. Many of them will help to create the conditions for economic activity and middle-class wage growth. Its proposals to lower middle-class tax rates, to expand means-tested post-secondary grants, to provide generous child benefits, and to increase financial support for public infrastructure, in particular, will be useful for Canada's middle class.

But there is more the government can do to deliver on this overarching policy objective. Here are some preliminary recommendations. We look forward to building on them in subsequent essays.

The new government has committed to review the plethora of federal tax expenditures with the goal of eliminating redundant and ineffective ones in order to generate fiscal savings. There is a strong case for this type of exercise. The federal government has not undertaken such a systematic review in nearly 30 years. The proliferation of tax expenditures over that period – including credits, deductions, and "special preferences" – has complicated the system, narrowed the tax base, and indirectly increased the size and scope of the federal government (Sheikh 2014). There is also evidence from the US that many of these policies tend

to disproportionately benefit high-income earners (Congressional Budget Office 2013). A comprehensive review with the goal of eliminating certain tax expenditures – particularly those which skew to high-income earners – could increase progressivity and create the fiscal room to lower marginal tax rates for low- and middle-class Canadians.

This type of tax reform could be further bolstered by other policies focused on rewarding work and investment while discouraging state dependence. An expansion of the Working Income Tax Benefit (WITB) is a good example. The WITB was created in 2007 to boost the earned income of low-income working individuals and families. The benefit is designed to reduce disincentives for people to enter and remain in the workforce due to the typical claw back of social assistance benefits (what economists call the “welfare wall”) and the costs associated with payroll tax deductions and work-related expenses. Some research shows that there is room to enhance the program, including increasing the maximum benefit and possibly raising the income threshold at which it applies (Battle and Torjman 2012), in order to “help make work pay.”

The new government has expressed a general predisposition to free trade. This is a positive development that returns the Liberal Party to its Laurier roots. Free trade agreements such as the recently-signed Trans-Pacific Partnership (TPP) ought to increase Canadian trade, productivity, and wages. The government should move forward with TPP’s prompt ratification. Opting not to ratify the agreement would deny Canadian businesses and workers market access to roughly 40 percent of the global economy and ultimately put us at a competitive disadvantage relative to the US to compete for investment and customers in these growing markets (Burney and Hampson 2015).

There is also much more to be done to reduce trade and economic barriers inside Canada. Interprovincial barriers represent a significant impediment to economic activity within the country. They have real, meaningful implications for middle-class Canadians in the form of higher prices, fewer employment opportunities, and ultimately lower wages. The Macdonald-Laurier Institute has published a series of papers with concrete recommendations to put an end to protectionism inside Canada.¹ The federal government has a vital role to play. Rather than continuing to let the provinces take the lead on this perennially disappointing file, the Trudeau government could use its constitutional powers to strike down provincial barriers and to establish an Economic Charter of Rights for Canadians and an Economic Freedom Commission to enforce it. That would be a meaningful reform to improve labour mobility and economic opportunity for low and middle-class workers.

Another important part of domestic and global market access is Canada’s trade infrastructure. The new government has committed to increasing federal funding for public infrastructure. This increased support can be useful if it targets transportation infrastructure, such as port capacity, critical to moving Canadian products to customers at home and abroad. But this type of investment will be undermined if other government policies make it more difficult to transport and ship Canadian exports. The new government should therefore reconsider its proposed ban on crude oil tanker traffic on Canada’s West Coast. Even conservative estimates of the 30-year economic benefits of expanded oil shipments from the Pacific coast are significant – with gross national product increasing by \$270 billion and labour incomes rising by up to \$48 billion over this period (Priddle, John, and Hage 2012). Banning oil tanker traffic – despite evidence that Canada’s record of tanker-based shipping has been responsible – would forfeit these economic opportunities. A plan to strengthen Canada’s public infrastructure ought to be matched with a suite of policies (excluding a moratorium on tanker traffic) that smooth the path for productivity-enhancing investments in pipeline projects.

The last Parliament was marked by a focus on consumer issues and it is likely the new government will want to develop a plan that speaks to consumer services and cost-of-living issues. Telecommunications policy is a good starting point. The current “fourth-player” policy prioritizes lower consumer prices over other considerations such as capital investment and network quality. This policy objective caused the previous

government to intervene in the market in order to subsidize new entrants in the name of lowering prices. Yet research shows that these underlying assumptions may not be right for Canada and may ultimately lead to less investment, poorer quality service, and even higher prices (Church and Wilkins 2013). A more ambitious consumer agenda would involve a neutral pro-competition policy that opened up protected sectors such as telecommunications, banking, and air travel (Globerman 2012; Masse and Beaudry 2015). Well-capitalised competition, based on market forces rather than state intervention, would support capital investment, greater service quality, and ultimately lower prices for consumers. Australia's experience with using competition rather than heavy-handed regulation to provide greater value for consumers provides a salutary lesson (Crowley 2013).

The new government has made housing affordability a top policy priority. There is considerable evidence that homeownership can serve as an escalator to the middle class and that the rising costs of owning a home is becoming a barrier for millennials and aspiring young families (New York Times Editorial Board 2014). Government policy must remember that housing prices are determined by housing supply and demand. But too often the public policy debate about housing affordability is focused on the demand side and ignores housing supply. The goal should be to first eliminate government constraints on housing supply, such as restrictive land-use regulations (Glaeser 2014). Many of these policies tend to fall under provincial and municipal jurisdiction, but the federal government can still play a critical role. The new government's infrastructure programme, for instance, offers a golden opportunity to attach strings that reward more intelligent housing policies at lower levels. The second goal should be to develop well-conceived policies to support demand. And most policies to bolster demand are actually the same ones that will promote economic and income growth because a strong economy and growing incomes and personal wealth are ultimately the major drivers of housing demand. A policy agenda that puts homeownership in reach for more middle-class Canadians would help the government achieve its goal of more inclusive growth.

CONCLUSION

The new government has identified middle-class wage growth and “inclusive growth” as its top policy objectives. These are laudable goals. Establishing the conditions for social mobility is one of the primary responsibilities of the federal government.

The key, though, is to ensure that any resultant policy agenda is rooted in the facts of the case and not rhetoric or an incomplete understanding. Public policy debates related to perceptions about income inequality here have tended to neglect evidence of strong social mobility in Canada and conflate our experience with that of the United States. This is not the basis for an evidenced-based policy. Instead, it sets up the risk of Canadian policy based on US evidence.

It is important, therefore, that before the government develops its policy programme, it has a firm understanding of the state of Canada's middle class. Only then can it ensure that its policies are addressing a real problem and doing so in an effective way.

This essay highlights some policy reforms that would help to bolster economic activity and middle-class wage growth such as reforming the personal income tax system to better reward work and investment, pursuing free trade and market access at home and abroad, opening up the Canadian market to greater competition, and supporting affordable and responsible homeownership. It should not be interpreted as exhaustive. Future essays will build on this foundation to set out specific recommendations to nurture and grow social mobility in Canada.

During the recent federal election the Liberal Party promised “real change” for Canadians. With the right mix of policies, the new government has a great opportunity to deliver real change for the better.

About the Authors



SEAN SPEER

Sean Speer is a Senior Fellow at the Macdonald-Laurier Institute. He previously served in different roles for the federal government including as senior economic advisor to the Prime Minister and director of policy to the Minister of Finance. He has been cited by *The Hill Times* as one of the most influential people in government and by *Embassy Magazine* as one of the top 80 people influencing Canadian foreign policy. He has written extensively about federal policy issues, including personal income taxes, government spending, social mobility, and economic competitiveness. His articles have appeared in every major national and regional newspaper in Canada (including the *Globe and Mail* and *National Post*) as well as prominent US-based publications (including *Forbes* and *The American*). Sean holds an M.A. in History from Carleton University and has studied economic history as a PhD candidate at Queen's University.



BRIAN LEE CROWLEY

Brian Lee Crowley has headed up the Macdonald-Laurier Institute (MLI) in Ottawa since its inception in March of 2010, coming to the role after a long and distinguished record in the think tank world. He was the founder of the Atlantic Institute for Market Studies (AIMS) in Halifax, one of the country's leading regional think tanks. He is a former Salvatori Fellow at the Heritage Foundation in Washington, DC and is a Senior Fellow at the Galen Institute in Washington. In addition, he advises several think tanks in Canada, France, and Nigeria. Crowley has published numerous books, most recently *Northern Light: Lessons for America from Canada's Fiscal Fix*, which he co-authored with Robert P. Murphy and Niels Veldhuis and two bestsellers: *Fearful Symmetry: the fall and rise of Canada's founding values* (2009) and MLI's first book, *The Canadian Century: Moving Out of America's Shadow*, which he co-authored with Jason Clemens and Niels Veldhuis.

Crowley twice won the Sir Antony Fisher Award for excellence in think tank publications for his health care work and in 2011 accepted the award for a third time for MLI's book, *The Canadian Century*.

From 2006–08 Crowley was the Clifford Clark Visiting Economist with the federal Department of Finance. He has also headed the Atlantic Provinces Economic Council (APEC), and has taught politics, economics, and philosophy at various universities in Canada and Europe.

Crowley is a frequent commentator on political and economic issues across all media. He holds degrees from McGill and the London School of Economics, including a doctorate in political economy from the latter.

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Endnote

- 1 For example, Crowley, Knox, and Robson (2010) make specific policy recommendations regarding a charter of economic rights to remove provincial trade barriers.

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- First book, *The Canadian Century: Moving out of America's Shadow*, won the Sir Antony Fisher International Memorial Award in 2011.
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"The study by Brian Lee Crowley and Ken Coates is a 'home run'. The analysis by Douglas Bland will make many uncomfortable but it is a wake up call that must be read."

FORMER CANADIAN PRIME MINISTER PAUL MARTIN ON MLI'S PROJECT ON ABORIGINAL PEOPLE AND THE NATURAL RESOURCE ECONOMY.

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About the Macdonald-Laurier Institute

What Do We Do?

When you change how people think, you change what they want and how they act. That is why thought leadership is essential in every field. At MLI, we strip away the complexity that makes policy issues unintelligible and present them in a way that leads to action, to better quality policy decisions, to more effective government, and to a more focused pursuit of the national interest of all Canadians. MLI is the only non-partisan, independent national public policy think tank based in Ottawa that focuses on the full range of issues that fall under the jurisdiction of the federal government.

What Is in a Name?

The Macdonald-Laurier Institute exists not merely to burnish the splendid legacy of two towering figures in Canadian history – Sir John A. Macdonald and Sir Wilfrid Laurier – but to renew that legacy. A Tory and a Grit, an English speaker and a French speaker – these two men represent the very best of Canada’s fine political tradition. As prime minister, each championed the values that led to Canada assuming her place as one of the world’s leading democracies.

We will continue to vigorously uphold these values, the cornerstones of our nation.



Working for a Better Canada

Good policy doesn’t just happen; it requires good ideas, hard work, and being in the right place at the right time. In other words, it requires MLI. We pride ourselves on independence, and accept no funding from the government for our research. If you value our work and if you believe in the possibility of a better Canada, consider making a tax-deductible donation. The Macdonald-Laurier Institute is a registered charity.

Our Issues

The Institute undertakes an impressive programme of thought leadership on public policy. Some of the issues we have tackled recently include:

- Getting the most out of our petroleum resources;
- Ensuring students have the skills employers need;
- Aboriginal people and the management of our natural resources;
- Controlling government debt at all levels;
- The vulnerability of Canada’s critical infrastructure;
- Ottawa’s regulation of foreign investment; and
- How to fix Canadian health care.

CELEBRATING



MLI

5 Years of True North in Canadian Public Policy

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What people are saying about the Macdonald-Laurier Institute

In five short years, the institute has established itself as a steady source of high-quality research and thoughtful policy analysis here in our nation's capital. Inspired by Canada's deep-rooted intellectual tradition of ordered liberty – as exemplified by Macdonald and Laurier – the institute is making unique contributions to federal public policy and discourse. Please accept my best wishes for a memorable anniversary celebration and continued success.

THE RIGHT HONOURABLE STEPHEN HARPER

The Macdonald-Laurier Institute is an important source of fact and opinion for so many, including me. Everything they tackle is accomplished in great depth and furthers the public policy debate in Canada. Happy Anniversary, this is but the beginning.

THE RIGHT HONOURABLE PAUL MARTIN

In its mere five years of existence, the Macdonald-Laurier Institute, under the erudite Brian Lee Crowley's vibrant leadership, has, through its various publications and public events, forged a reputation for brilliance and originality in areas of vital concern to Canadians: from all aspects of the economy to health care reform, aboriginal affairs, justice, and national security.

BARBARA KAY, NATIONAL POST COLUMNIST

Intelligent and informed debate contributes to a stronger, healthier and more competitive Canadian society. In five short years the Macdonald-Laurier Institute has emerged as a significant and respected voice in the shaping of public policy. On a wide range of issues important to our country's future, Brian Lee Crowley and his team are making a difference.

JOHN MANLEY, CEO COUNCIL