

Taxation and Income Inequality

A major discussion is ongoing in Alberta, as a prelude to the budget the Government of Alberta will bring down for fiscal year 2015/16. This discussion has arisen owing to the collapse of the Government's usual source of funding for a large portion of its activities: natural resource extraction royalties. Given the nature of natural resource market pricing and the Government's unwillingness to develop a coherent, long-term revenue budgeting framework, Alberta's residents are subjected to these cyclical fluctuations in the revenues available to support Government activities on a routine basis.

This time around, residents of Alberta are being told that the Government is finally going to fix this problem for the long-term. That is, alternate sources of revenues will be sought. Also, expenditures will be cut by up to 9%, relative to what would have been the case in the absence of the collapse of the world price of oil. Although we are also being told by the Government that it is considering all of its revenue-raising options, it has already ruled out several major ones: the introduction of a provincial consumption tax, an increase to the corporate tax rate, and an increase to resource extraction royalty levels.

It has been mooted that there will be a change to the Alberta "flat tax" on personal income, perhaps with a concomitant move to "progressivity" of this tax. That is, those earning higher incomes being subjected to higher percentage tax rates, at those higher income levels. This notion is met with some approval on the part of various groups. In principle, many seem to believe that "fairness" dictates that higher income earners "ought" to be paying a higher tax rate on their higher income. But, this is mostly a value judgement, not an economic argument in and of itself.

Over the past thirty years, income inequality has risen significantly in most OECD countries. This is considered a problem, since empirical evidence has shown that, as income inequality has increased, economic growth has declined. Numerous reasons are cited for this, including a vicious cycle making it less worthwhile for low income earners to invest in improving their labour market skills since this offers them low returns, leading to lower productivity in this labour market cohort, and concomitant further reductions in earnings. This then leads to even greater income disparities over time, with further economic growth-deteriorating effects.

One solution proposed to reverse the trend in increasing income inequality has been to make the income tax system more progressive. That is, by taxing higher income earners at higher rates, and distributing resulting revenues to lower income earners (usually via deductions against income, or tax credits), income inequality will be reduced. This reduction in inequality will then, it is argued, stimulate economic growth. However, recent research for OECD economies has shown that increased tax progressivity leaves income inequality unaffected. The reason for this is that, with changes to the tax system, the incentive system for workers changes significantly, thereby affecting labour supply and skill investment decisions. These behavioral changes then circumvent the tax change

effects, thereby defeating the objective of reducing income inequality through that tax policy tool.

How, then, does one combat the negative effects on economic growth of income inequality, through efforts to reduce that inequality? Further evidence on the experience in OECD countries has shown that government expenditures supporting various social policies (for example, early childhood education systems, public health services, and subsidised provision of universal daycare) are far more effective in reducing income inequality. These policies, which are of greater proportional benefit to low income earners, directly reduce income inequality, then have second-round effects when coupled with a tax system which does not introduce distortionary effects on economic behavior, and does not disincentivise productive behaviour. The resultant incentive system then encourages investment in labour market skills, increases labour productivity further, and society as a whole can gain.

To decide what it will do in our current fiscal mess, the Government has established a cabinet task force, to look at competing options. The Government is also soliciting feedback via surveys and town hall events, where the public can express its opinion on what should be done. So far, this public feedback has been one of the catalysts causing the government to rule out the revenue options referred to earlier, and to fixate on the need to tweak the income tax system, perhaps to move it back towards a more progressive system. As noted above, this is not a winning strategy, given the evidence from OECD economies. In addition, the focus to cut expenditures by up to 9% will have a significant impact on social programmes, and will therefore work in the *opposite* direction needed to reduce income inequality, and to stimulate economic growth.

It *is* important to listen to what the public say, but governing via opinion polls, which seems to be what is presently afoot, can lead to severely limiting and outright bad choices. The Government has a duty to show leadership, through properly advising the public on options and trade-offs which are available, and paying due heed to the empirical evidence around us in arriving at the best overall solution. So far, the Government's willingness to be swayed by political considerations does not breed optimism on the tax policy the Government will implement in the 2015/16 Alberta budget.

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