ECONOMIC NOTE

Montreal Economic Institute
Ideas for a More Prosperous Nation

Should We Worry about Income Gaps?

by **Yanick Labrie**

The "Occupy Wall Street" movement, which spread to many cities around the world last fall, once again brought the never-ending question of income inequality to the forefront of public debate. Concerns about this issue have also been fed by studies that have appeared over the past year, especially those from the Conference Board of Canada and the OECD.[1] However, even though these studies present data showing that income inequality in Canada has been tending to increase, the interpretation of their conclusions is not as obvious as it might appear at first glance. Like other studies carried out in the past, these bump up against the problem of collecting data in order to sketch a precise, unequivocal picture of the scope of inequality.

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This *Economic Note* discusses five important factors that amend this picture and that suggest that the phenomenon of inequality is probably less worrisome than many groups often make it out to be.[2]

1. The data used to measure the extent of economic inequality is of limited quality

Studies on the phenomenon of income inequality rely on statistics that originate either from income tax returns or from poll or census surveys. In either case, despite efforts made to refine the statistics in recent years, it must be said that the income data collected still contain certain flaws.[3] Results are likely to be distorted, especially because of significant amounts of revenue that are not fully declared.[4]

For example, according to one study, from 12 to 24% of self-employed Canadian workers' income is not declared to the taxman.[5] Furthermore, a Statistics Canada study showed that the rate of underreporting in surveys is around 15% for Employment Insurance income and 50% for social assistance income.[6] The fact that these sources of income affect people of modest incomes first and foremost contributes to the overestimation of the phenomenon of inequality.

Black market activities also have the potential to distort the income gap picture, especially if people from different income categories do not engage in such activities at the same rate. Research carried out in order to estimate the size of the underground economy has shown that it represented nearly 16% of GDP during the first decade of the 21st century.[7]

2. Standards of living are less disparate than suggested by the data on income gaps

Even if we could improve our income data collection methods, income is probably not the best measure to use for comparing standards of living within a given population. Insofar as people's primary concern is their ability to acquire goods and services allowing them to maintain an adequate standard of living, the use of a measure of consumption levels is more appropriate than a measure of income.[8]

For example, people can generally stabilize their consumption levels through time by means of loans and savings, in order to alleviate the income fluctuations that occur throughout their lives.[9] And indeed, people do have a tendency to borrow when they are young, in order to finance studies or

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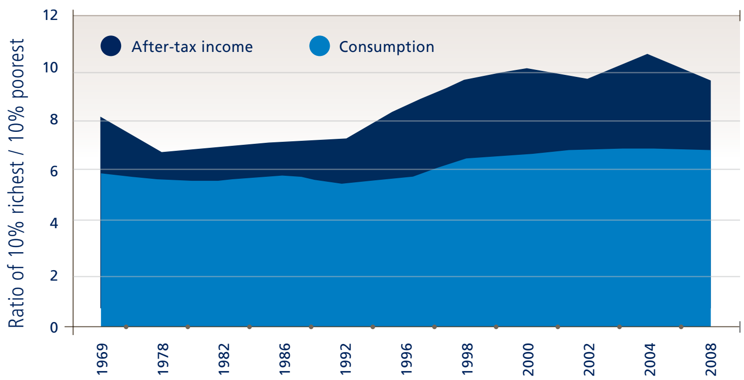
Figure 1
Evolution of income and consumption inequalities between the richest 10% and the poorest 10% of Canadian households



Sources: Chris Sarlo, *The Economic Well-Being of Canadians: Is there a Growing Gap?* Fraser Institute, May 2009; Jason Clemens, *Income Inequality: Oversimplifying a Complicated Issue,* April 2012. Note: Income is adjusted to take family size into account.

buy property for instance, and to save more and more as their incomes rise with age. Similarly, savings accumulated over the course of a lifetime allow people to build assets and maintain their standards of living after retirement when their employment incomes have fallen.[10]

Insofar as people's primary concern is their ability to acquire goods and services allowing them to maintain an adequate standard of living, the use of a measure of consumption levels is more appropriate than a measure of income.

Since fluctuations in consumption are less volatile than income fluctuations, it is not surprising to find that consumption gaps within the population are much narrower than income gaps.[11] In Canada, not only has consumption inequality over the past thirty years been less pronounced than income inequality, but it has changed very little over this period (see Figure 1).[12]

Moreover, many goods and services are becoming accessible to an increasing number of people. While not so long ago, a good number of consumption products were the privilege of a tiny, wealthy minority, these same products are now accessible to a majority of the population, including those of modest means.[13]

For example, among the 20% of the Canadian population with the lowest incomes (bottom quintile), around half own a car, a cellphone, a personal computer and have an Internet connection at home, and more than three quarters have either cable or satellite television.[14] These are goods and services to which even the wealthiest billionaire did not have access mere decades ago.

Inequality measured on the basis of income therefore paints a very misleading picture of the real level of inequality in terms of a society's standards of living.

3. Increasing income inequality can go hand in hand with a decreasing poverty rate

Although the distinction between the phenomenon of poverty and that of income inequality might seem obvious, it is commonplace to hear certain commentators discuss these phenomena as if they were two sides of the same coin.[15] It is nonetheless altogether possible to imagine a situation in which the poverty rate is falling at the same time as income inequality is rising, or to imagine the reverse situation.

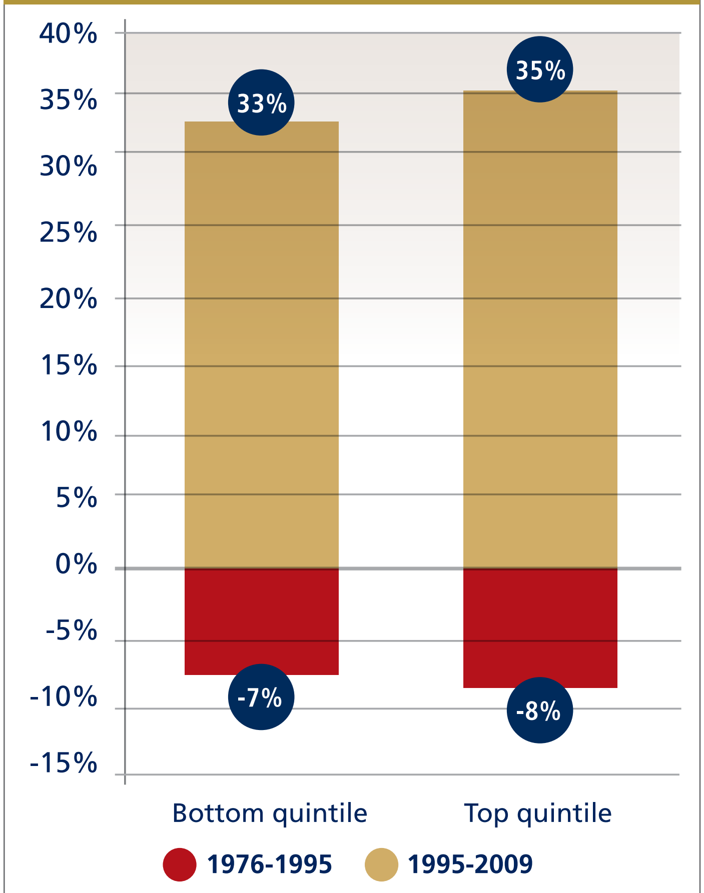
In fact, from 1976 to 1995, a period during which income inequality in Canada remained relatively stable, average after-tax household income for the poorest quintile rose barely 4% in Canada, and actually fell 7% in Quebec, taking inflation and household size into account.[16] On the other hand, from 1995 to 2009, a period that according to many was characterized by increasing inequality and a scaling back of redistributionist measures by governments,[17] the average after-tax household income for the poorest quintile rose 23% in Canada and 33% in Quebec (see Figure 2). During this same period, the proportion of people below the low income cut-off went from 14.5% to 9.6% in Canada and from 17.6% to 9.4% in Quebec.[18]

Accordingly, if the main goal is to reduce the incidence of poverty within the population, headlines should be trumpeting the considerable improvement over the past fifteen years on this count, not the alleged rise in the income gap.

4. Not taking into account the changing composition of households overestimates the scope of inequality

Given that measures of economic inequality are usually calculated based on household data rather than individual data, it is important to take into account the changing composition of these households over time. Among other things, the number of single-parent households in

Figure 2
After-tax income for Quebec households (bottom and top quintiles)



Source: Statistics Canada, CANSIM Table no. 202-0706. Note: Income is adjusted to take inflation and family size into account.

Canada has risen considerably in recent decades, going from 10% in 1976 to 16% in 2006.[19]

These changes in household composition have appreciable consequences for the calculation of income gaps, insofar as single-parent families are more likely to find themselves in the lowest income category. In Quebec, and in Canada as a whole, the proportion of single-parent households living below the low income cut-off after taxes in 2009 was 18%.[20]

Furthermore, the differences in household size are very large from one income bracket to another. In Quebec for example, the households that belong to the lowest income bracket (bottom quintile) include 1.3 people on average, while those belonging to the highest income bracket (top quintile) include 3.3 people on average.[21] Under these circumstances, comparing the incomes of households of different sizes (and that are changing over time) is like comparing apples and oranges.

Statistics Canada carries out an adjustment to household data in order to take into account the fact that people living under one roof enjoy economies of scale. This simple adjustment, which aims to make households comparable from one income group to another and through time, is such that the extent of inequality, both in terms of income and in terms of consumption, is 30% lower than the unadjusted statistics would lead us to believe.[22] According to a recent study, the greater part of the (small) increase in family income inequality in Canada from 1995 to 2005 is attributable to the constant rise in the number of single-parent families and of people living alone during this period.[23]

5. Economic mobility is high in Canada and even more so for those with low incomes

Headlines are full of references to the "rich" and the "poor," as if these groups were made up of the same families year after year.[24] In actuality, studies of the Canadian data show that on the contrary, economic mobility in Canada is among the highest for Western countries.[25] In other words, far from being confined to a single income class their whole lives, the position of Canadian households in terms of income level is continually changing.

It is possible to imagine a situation in which the poverty rate is falling at the same time as income inequality is rising, or to imagine the reverse situation.

Statistics Canada published an exhaustive study regarding the evolution of the incomes of specific households over a period of five years. By analyzing these data, it becomes clear that it is the poorest 20% who enjoy the highest upward economic mobility. Indeed, 43% of people who made up the bottom income quintile in 2005 found themselves in a higher income quintile before the end of the five-year period.[26] In addition, only 2.1% of people remained below the low income cut-off each and every year from 2002 to 2007.[27]

Other researchers have focused on intergenerational economic mobility. Once again, Canada posted impressive results: fewer than 16% of sons whose fathers were among the bottom income decile (the poorest 10%) remain in this group once they reach adulthood.[28]

These results show that economic mobility is high in Canada, especially for low income individuals.

Conclusion

In a poll carried out in 2009, over two thirds of Canadians said that they considered it more important for each person to have a chance to improve his or her economic conditions than to reduce inequality.[29]

The greater part of the increase in family income inequality in Canada from 1995 to 2005 is attributable to the constant rise in the number of single-parent families and of people living alone during this period.

Inequality can certainly become a harmful phenomenon when a large number of people believe that their society is unfair and when social mobility is so low that it becomes pointless to try to improve one's lot. But this is not the case. Our analysis shows on the contrary that the phenomenon of inequality is clearly less worrisome – and social mobility is much higher – than alleged by those who promote greater nationalization of the economy.

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