Inequality and Growth: A Case for Inclusive Growth Policies

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The third industrial revolution and the digitalisation of our economies has gone hand in hand with increased labour market polarization and, reflecting the comparatively large weight of earnings among households' economic resources, a trend rise in inequality of household disposable income. In this context and important role of governments is to pursue pro-growth policies that at the same time are inclusive and take thus their effect on the distribution of income into account This note briefly summarises key trends in income inequality and then discusses the potential contribution of growth-enhancing policies to these developments by reporting preliminary evidence on the effect of growing inequality on the long-term level of GDP.

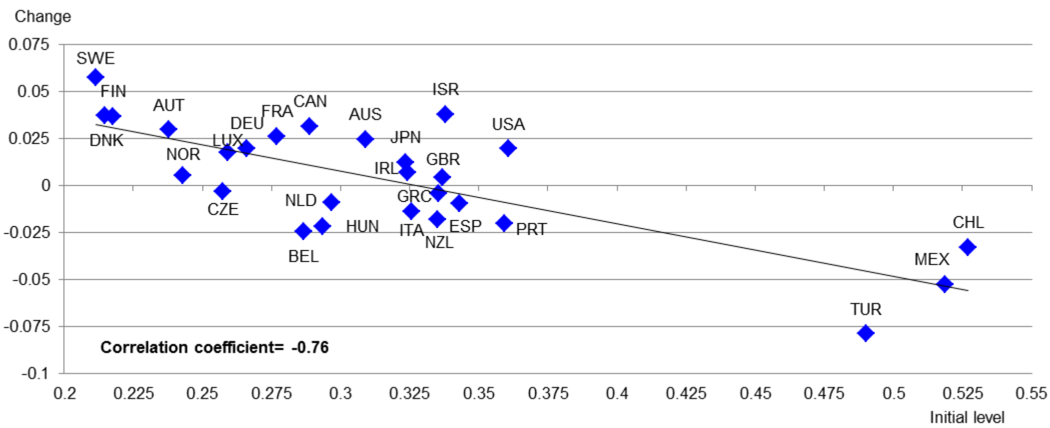
Key trends in growth and income inequality

Trends in overall income inequalities across OECD countries have been well documented in previous reports (OECD, 2011, 2015). Income inequality has risen in the majority of OECD countries during the past three decades. According to one traditional measure –the Gini coefficient– income inequality has risen by 10 per cent on average across countries from the mid-1980s to the late 2000s, while the ratio of the top-to-bottom income decile reached its highest level in 2010. As top incomes are under-reported in surveys, the rise in inequality is probably understated.

However, the rise in income inequality has been far from uniform across countries, and a trend decline has been observed in a number of them (Figure 1). In fact, between the mid-90s and the late 2000s, OECD countries experienced a form of "inequality convergence", with marked and opposite-sign changes in overall disposable income inequality for the most and the least unequal countries. The largest increases in inequality were observed in Sweden, Denmark and Finland, which nonetheless remain among the most egalitarian countries, while the sharpest reductions were recorded in countries such as Turkey, Mexico and Chile, which started from a high level of inequality.

Figure 1. OECD countries have experienced inequality convergence

Change in Gini coefficient against initial level: Mid-1990s to late 2000s

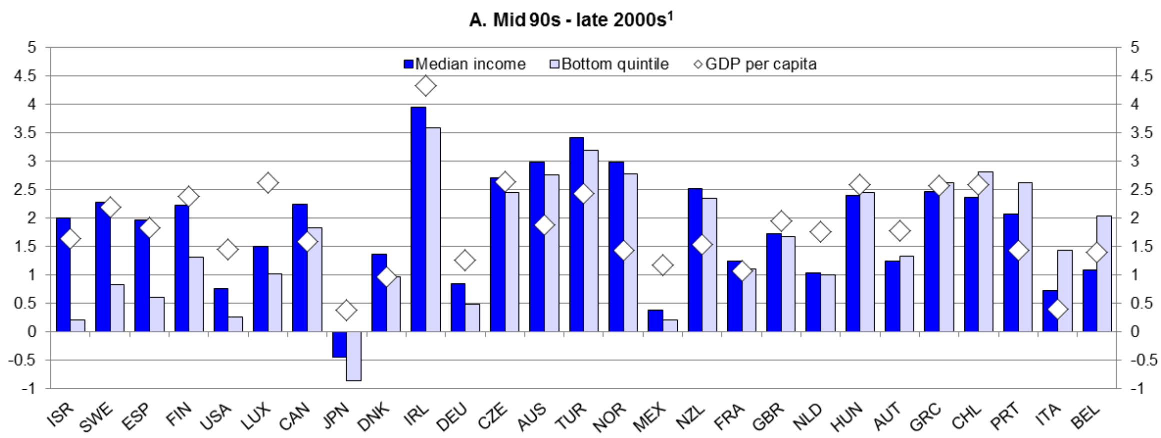


Note: Mid 90s refer to 1995 except for Austria for which the data refer to 1993, for Czech Republic, France, Luxembourg and Chile for which the data refer to 1996, for Greece, Ireland, Mexico, Turkey and the United Kingdom *for which the data refer to 1994. Late 2000s refer to 2009 except for Australia, Canada, Denmark, France, Germany, Israel, Mexico, the Netherlands, Norway, Sweden, the United Kingdom and the United States for which the last* available observation is 2010, for Korea for which it is 2011 and for Switzerland for which it is 2008.

Source: OECD Income Distribution Database

Moreover, gains in disposable income have for a large proportion of households fallen short of increases in GDP (Causa *et al*., 2014a).
– This has been particularly the case for households at the bottom of the distribution: in around half of the OECD countries, GDP growth was substantially higher than households' income growth in the lowest quintile (Figure 2).
– In comparison to disposable incomes at the bottom of the distribution, disposable income in the middle of the distribution have generally fared better, even though they have also lagged GDP growth in a large number of countries.
– A few countries have seen widening disparities in the lower half of the income distribution even as overall inequality has narrowed. This pattern was particularly striking in Spain, reflecting strong increases in income disparities between bottom and middle income households. This illustrates that trends in summary indicators of inequality such as the Gini coefficient can mask diverging developments across different portions of the income distribution.
– Meanwhile, in other countries (*e.g*. Australia, Canada, New Zealand, United Kingdom and the United States), between 20% and nearly 50% of total income gains have accrued to the top one-per cent of households, pointing to rising inequality also within the upper half (OECD, 2014).

Figure 2. In many OECD countries, low-income households have benefited little from GDP gains
Real average annual growth rates of GDP, median and bottom quintile across OECD countries (%)



Note: For median and bottom quintile incomes, Purchasing Power Parities (PPPs) are those for private consumption of households. For GDP per capita, PPPs are those for the GDP deflator. Countries are sorted in ascending order according to the difference between the annual average growth rates of median versus bottom quintiles incomes.
Source: OECD calculations based on OECD National Accounts and Income Distribution Databases.

What effects do growth-enhancing policies have on income inequality?

The main upshot from these developments is twofold: first, in a majority of OECD countries, GDP growth over the past two or three decades has been associated with growing income disparities,[1] suggesting that some of the forces driving GDP growth –including policy changes— may also have fuelled inequalities. Second, differences in the sources of the changing income distribution –both within and across countries– means that identifying the key sources of trade-offs between growth and equity is no simple task.

To shed light on this issue, the extent to which structural policies have had differential long-run impacts on GDP per capita and household income, on average and at different points of the distribution has been investigated (*Causa et al*., 2014b). In principle, domestic production (or income) should drive households' income developments. This implies that GDP per capita and average household disposable income should move in parallel, at least over a sufficiently long period. As mentioned above, this has not been the case for many OECD countries over previous decades. In fact, some policies may have an impact on household disposable income that is different from that on GDP. This will be the case, for instance, if such policies induce income transfers between economic sectors (i.e. household, public and corporate sectors) that persist long enough to create a wedge between GDP per capita and household disposable incomes.

One purpose of the analysis is to see whether policies and institutions that have been found to have a favourable impact on the long-term level of GDP per capita, have benefited household disposable income in similar proportions. The results suggest that growth-enhancing policies have generally benefited the average household, but with a magnitude that in several cases differs from the impact on GDP per capita. More specifically:

– Reducing barriers to competition, reducing unemployment benefits across the board and lowering labour taxation are found to lift incomes of the average household by more than GDP per capita.

– Boosting ICT investment and tightening unemployment benefits for the long-term unemployed are found to lift incomes of the lower middle class by less than GDP per capita – the latter reform is even found to reduce disposable incomes of the lower middle class.

Another purpose of the analysis is to identify potential policy trade-offs and synergies between economic efficiency and income inequality. Inequality is measured for household disposable income, which implies that estimated policy effects encompass effects on both the employment and wage dispersion: this is important for interpreting the results because a number of policies, for instance labour market policies, have been found in previous studies to raise the level of employment as well as wage dispersion, with an ambiguous effect on overall inequality. As a result, the "net" impact of policies depends on the strength and interplay between the employment and wage channels, which are subsumed in the analysis considered here.

Indications on the effect of growth-enhancing policies on income distribution are obtained by comparing the impact of policies on the disposable income of poor households and the lower middle-class relative to that of the average household. Reforms can be distinguished according to whether they increase, reduce or have no impact on disposable income inequality:

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1. In some OECD countries, increasing inequality has also been driven by rising unemployment in a context of stagnant GDP.

– Several growth-enhancing policies are found to deliver stronger income gains for households at the bottom of the distribution compared with the average household, and can thus narrow disposable income inequality. This is the case, for instance, of reducing regulatory barriers to domestic competition, trade and inward FDI, as well as stepping-up job-search support and activation programmes.
– Conversely, a tightening of unemployment benefits for the long-term unemployed lifts GDP per capita and average household income but also reduces disposable incomes at the bottom of the distribution, an indication that it may raise inequality.
– Finally, a few policies leading to higher GDP per capita have an impact on household income that is not markedly different across the distribution. Examples include measures that raise the average level of education of the working-age population as well as reductions in the marginal tax wedge on labour income.

One clear source of tension between growth and income inequality that has been identified in recent studies is technological progress. The finding that trend productivity growth or higher investment in innovation raises income inequality supports the view that technological progress creates proportionately more high-skill, better-paid jobs. This is possibly reflected in the finding that the lower-middle class has benefited less on average from the gains in GDP per capita than households in the upper-half of the distribution. Earlier studies have shown that improving skills through broader access to high-quality education is the best way to offset the inequality impact of technological progress (Braconier *et al.*, 2014). The findings reported above indicate that promoting product market competition can reduce income inequality, while boosting productivity. This is the case regardless of whether competition is encouraged through lower regulatory barriers to firm entry or via stronger exposure to foreign trade and FDI. In fact, one finding that is common to most studies is that once controlling for technological progress, there is little evidence to suggest that globalisation exacerbates income inequality.

How can pro-growth policies be made more inclusive?
It is noteworthy that many pro-growth policies can be favourable to both economic growth and a narrowing of the income distribution. This finding could reflect that policy-driven increases in employment tend to dominate policy-driven increases in wage dispersion. Nevertheless, given the need to pay attention to rising inequality in many countries, priority should be given to policy packages that both reduce income dispersion and boost growth.

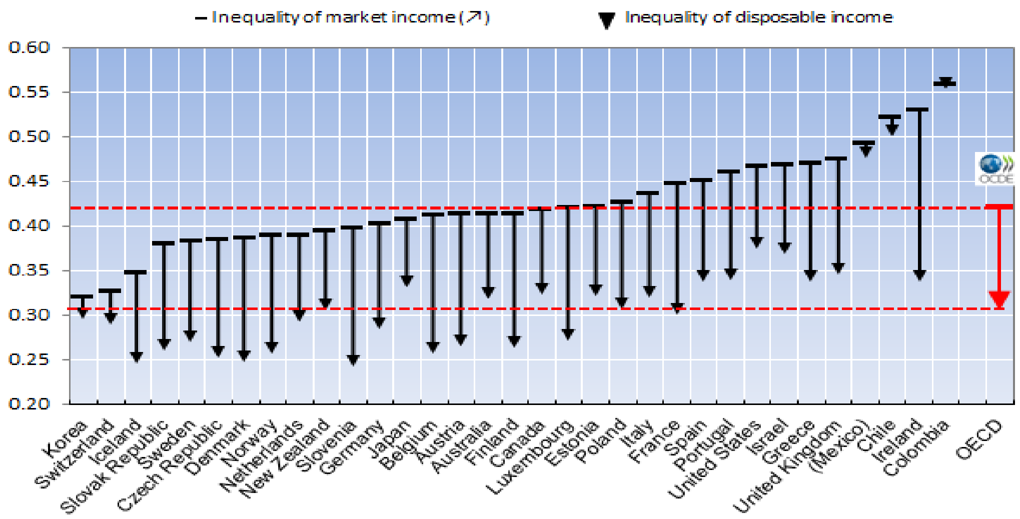
Increasing the provision and quality of education and training is an example of policies that contribute both to economic growth and equity. Particular emphasis should be put on equal access to early, primary and secondary education as well as in evenly high quality of basic education, in order to prevent the exclusion of socially or economically disadvantaged groups from the labour market. Also, broader access to higher education, vocational education and training as well as life-long re-training opportunities reduce the impact of skills-biased technical change on wage inequality. Access to up-skilling will be an important policy for more inclusiveness in knowledge-based economies.

Removing obstacles to the labour force participation of women is another policy that enhances growth and reduces income inequality. One priority in this area is to reduce the financial disincentives to return to work after childbirth, including specific features of the tax-benefits system, such as high taxes on second earners and ill-targeted childcare support. Making tax allowances and transfers conditional on the second earner's income rather than on family income, or expanding childcare support conditional on employment (such as childcare subsidies or paid maternity leave) are likely to reduce such disincentives. Furthermore, expanding the access to affordable childcare services is also likely to encourage the full-time labour participation of women, thus reducing inequality.

Reducing regulatory barriers to entry and competition in sectors with large potential markets is associated with a large employment effect, which is likely to reduce income inequality (Figure 3). A recent OECD study (Criscuolo *et al.*, 2014) provides strong evidence of a disproportionally large role by young firms in job creation. This suggests that reducing barriers to entrepreneurship can contribute significantly to income equality via the employment effect.

Progressive tax and transfers systems contribute to reduce income inequality, but associated redistributive effects are highly heterogeneous across countries (Figure 3). This partly reflects differences in social preferences, in particular inequality aversion. Redistributive policies require striking a balance between equity and efficiency, but policy packages can be designed to exploit synergies between the two objectives. While enhancing income redistribution, raising marginal tax rates can entail non-negligible economic costs. By contrast, enhancing the efficiency of the tax system, such as cutting back tax expenditures, broadening tax bases and fighting tax evasion involves much smaller costs or even benefits in terms of growth. Associated policies would reduce income inequality especially if targeted at those tax expenditures that are mostly benefitting higher-income households.

Figure 3. Redistribution reduces inequality but the magnitude differs between OECD countries



Note: Data refer to the working-age population.

Source: OECD (2013), Crisis squeezes incomes and puts pressure on inequality and poverty.

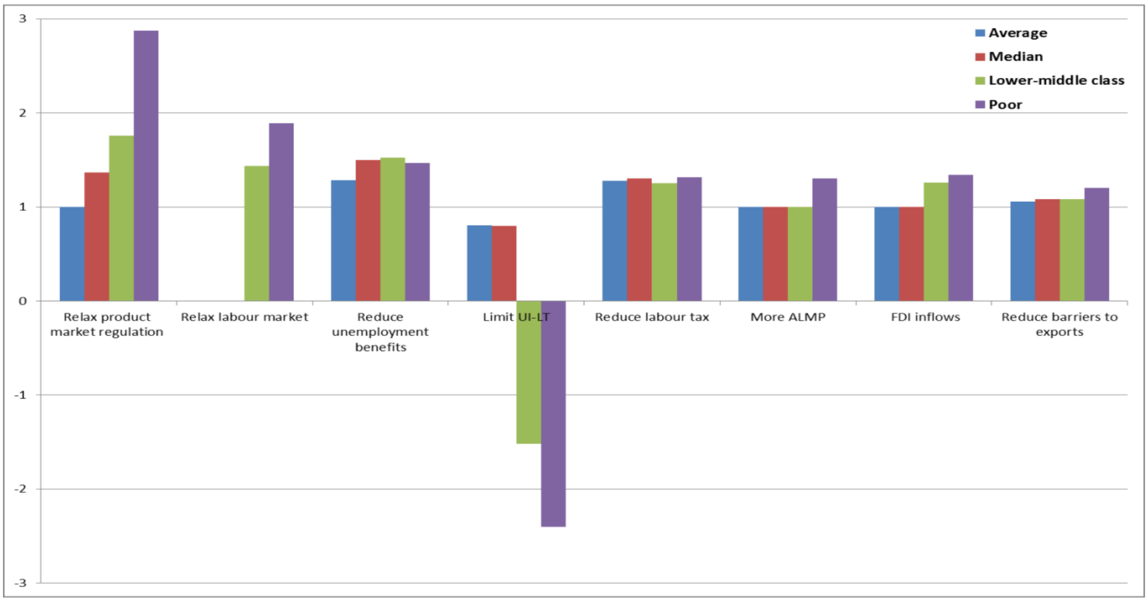
Some policies call for careful implementation that takes into account their potential adverse equity effects. For instance, in reforming unemployment benefits, special attention needs to be given to the long-term unemployed. Because of their bleaker employment prospects, tightening benefits for this group can exacerbate poverty unless matched by other forms of social protection or targeted requalification measures (Figure 4). This also implies that unemployment benefits and active labour market policies should be primarily geared towards shortening the unemployment spell.

In a similar vein, policies that tighten access to early retirement and disability benefits require a careful employability assessment. Such policies may widen income inequality if the prospect of finding a job that compensates for the loss of social transfers is low. Activation services and retraining opportunities extended but targeted to those groups (which are currently under-represented in such programmes) become an important policy for enhancing both growth and equity as working lives are progressively extended.

Employment protection legislation is another policy area with potentially large effects on income inequality. Reforms of employment protection should focus on reducing the gap in the degree of protection between temporary and regular contracts. Such policies reduce income inequality through effects on employment and wage dispersion: where excessively strict, an easing of regulatory constraints on the dismissal of workers on regular contracts would encourage more hiring on such contracts, preventing thereby employment to be biased toward temporary workers. Insofar as dismissals entail the loss of wage income, the easing of employment protection legislation should be coupled with a reform of unemployment benefits to provide adequate coverage to all workers. In this regard, shifting protection from jobs to workers brings higher efficiency and equity.

Reforms of taxes and transfers have direct consequences for income inequality since they are the most important instruments of redistribution. For instance, changing the tax structure in a way that lowers the weight of direct taxes while relying more on indirect taxes is favourable for growth but may increase inequality through various channels such as the likely adverse effects of relatively higher consumption taxes on less affluent households. However, the impact can be reduced if the tax shift is achieved by lowering the labour tax wedge on low-income households through in-work tax credits and other income-conditional tax allowances. This preserves the redistributive capacity of the tax-benefit system while further enhancing equity by encouraging the labour force participation of low-income households. Raising the taxation of immovable properties and inheritance would probably raise the progressivity of taxation.

Figure 4: Pro-growth policies and income distribution



Source: based on Causa, O., A. de Serres and N. Ruiz (2014), "Can growth-enhancing policies lift all boats? An analysis based on household disposable incomes", OECD Economics Department Working Papers 1180, OECD Publishing.

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