

The Growth and Inequality Nexus: an OECD perspective

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Motivation

- The growth and inequality nexus is not new: during the 1950's, economists such as Kaldor and Kuznets argued about a **possible trade-off between the two**
- During the post-war period, East Asian economies experienced high growth and declining inequality, while Latin American countries experienced the high growth and increasing inequality
- Renewed interest for the question in the aftermath of the crisis : **when growing unequal, are we growing less than we should?**
- **Does the quest for greater equality systematically lead to more growth?**

In theory

- Many possible links between inequality and growth
 - Causality can go **both ways**
 - Different mechanisms can be relevant for **poor and rich countries**
 - (low,high) growth \leftrightarrow (low, high) inequality
 - Everything in the middle is a grey zone depending on **country specific circumstances**
- Inequality can influence growth through **opportunities** for specific income groups (the poor, the middle class, the rich)
- No general mechanism, the channels depend on also **the structure of the income distribution.**
- Therefore, **a granular approach is essential**

In theory

- Greater inequality might ***increase*** growth if:
 - **Incentives:** inequality provides the incentives to work harder, invest and undertake risks (**all the distribution**)
 - **Savings and investments:** higher inequality fosters aggregate savings and therefore capital accumulation because the rich have a lower propensity to consume (**the rich**)

In theory

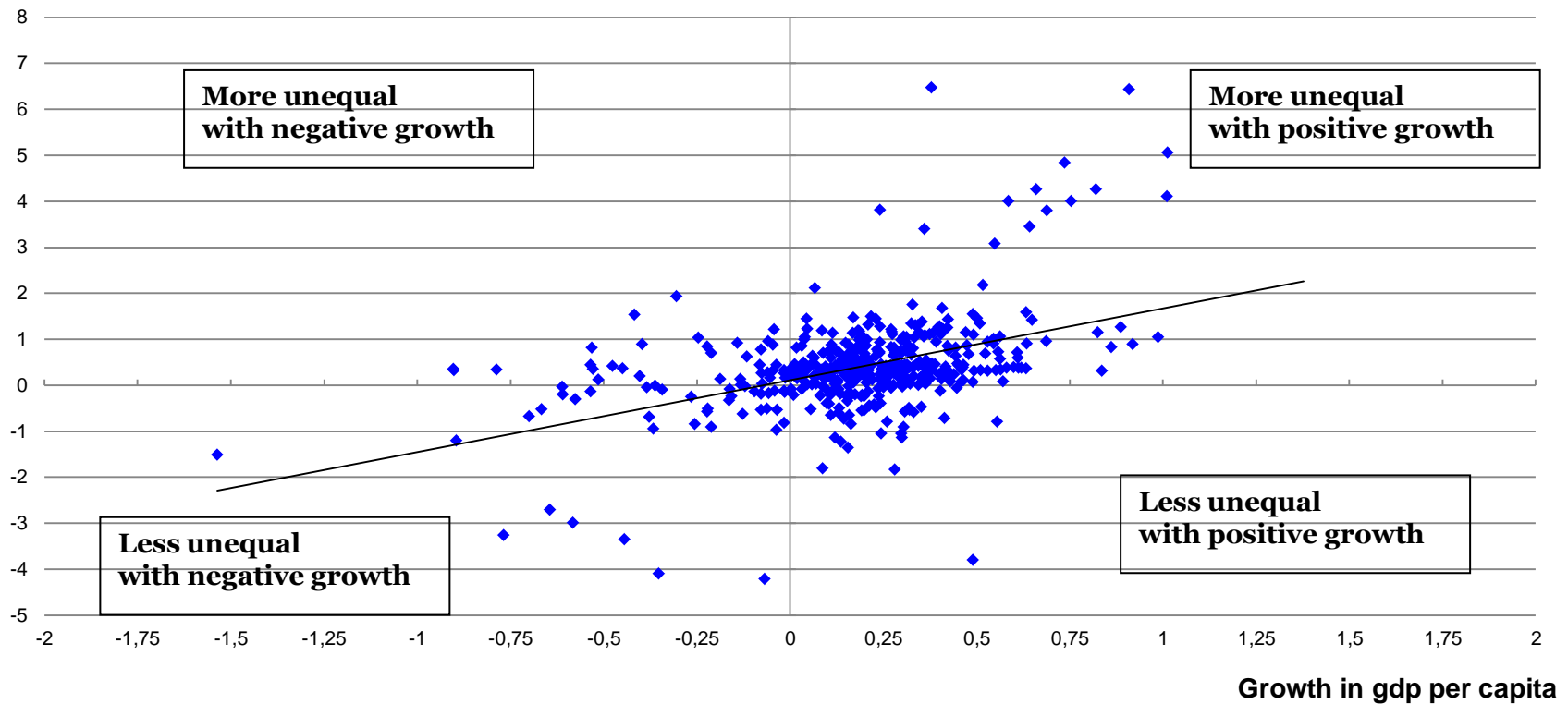
- Greater inequality might **reduce** growth if:
 - **Endogeneous fiscal policy**: greater inequality becomes unacceptable to the shrinking middle class, so they insist on higher taxation and regulation (**the median voter**)
 - **Human capital accumulation**: liquidity-constrained households in the bottom of the distribution underinvest in education (**the poor**)
 - **Domestic demand**: small domestic demand limits incentives for investment and innovation (**the middle class**)
 - **Lobbying and corruption**: higher inequality can lead to rent-seeking and misallocation of resources (**the rich**)
 - **Polarisation, trust and social conflicts**: low inequality can foster cooperation and political stability, which may improve efficiency and growth (**all the distribution**)

In practice

No clear relationship between inequality and growth

Mid 90s - late 2000s

Change in inequality



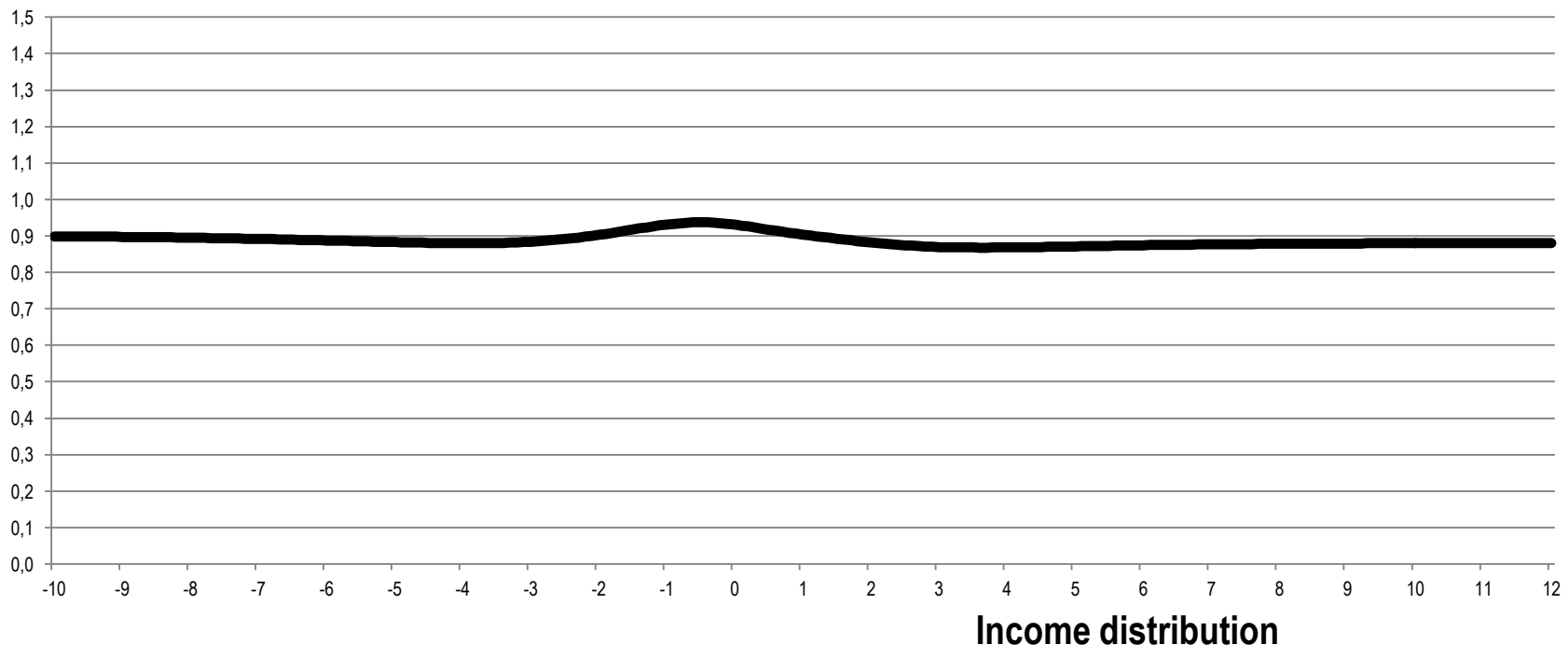
Is there a negative effect of inequality on growth?

- Yes, according to recent evidence (OECD, 2015; IMF, 2014):
 - Inequality in **after taxes and transfers income** has a negative effect on growth, streaming mainly from the human capital accumulation story
- But this needs to be qualified:
 - **No one-size-fits-all** : average effects do not take into account country-specific circumstances
 - **In particular starting point and non-linearity**: too much inequality is likely to harm growth, but too much equality may have the same effect. Moving in-between, there is a range of possibilities with no clear trade-offs
 - **Inequality of opportunities is what matters at the end**: income inequality differs from inequality of opportunities in policy-relevant ways. While income inequality increased in Denmark, poverty remained unchanged and specific policies focus on equal opportunities (ex: access to education, generous student grants in Denmark); gender equality increases opportunity but also income inequality...
 - **Social welfare perspective**: social preferences establish the growth vs. inequality trade-off; the democratic process puts it in practice

Are we necessarily growing unequal?

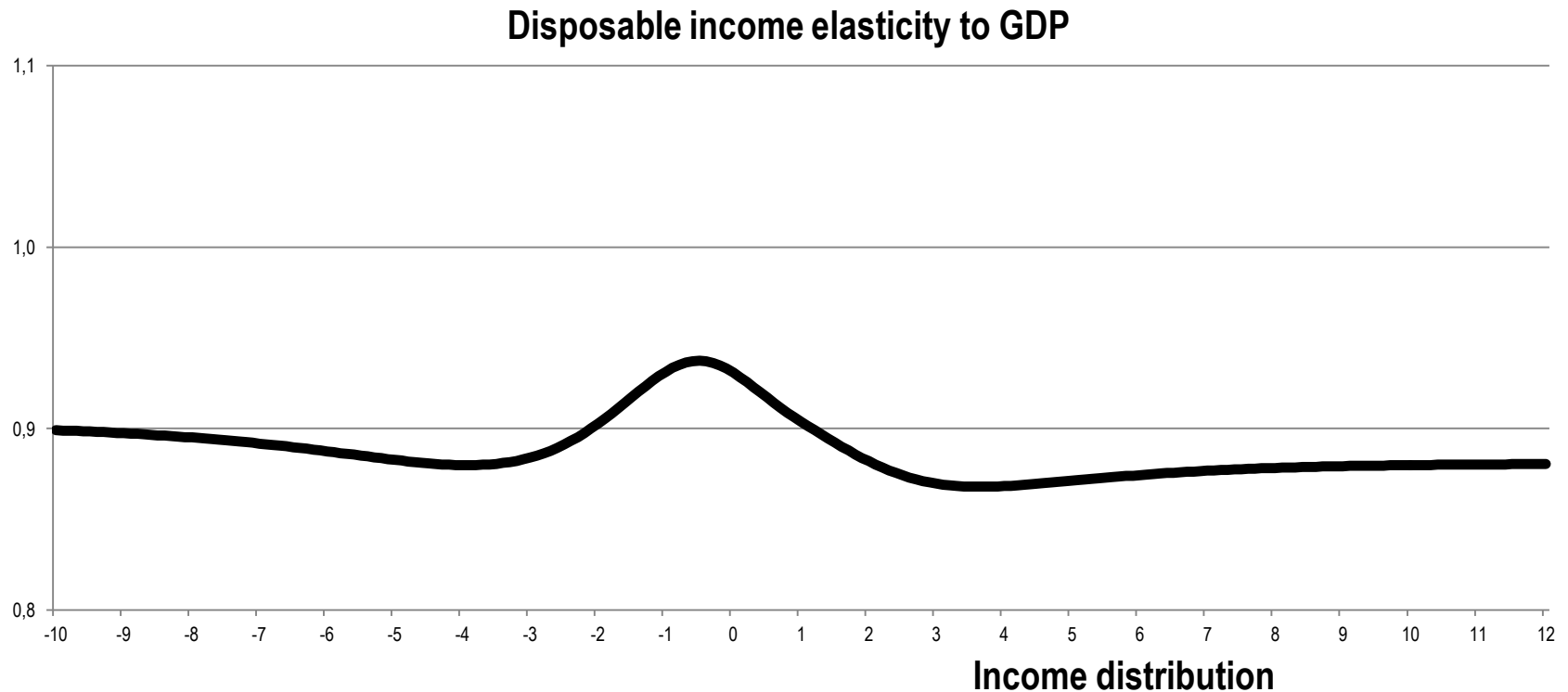
- No, growth is estimated to have a **neutral effect on the distribution of household disposable income (i.e. post-tax & transfer)**
- **Income redistribution** through taxes & transfers is essential to mitigate inequality and doesn't harm growth **up to a certain limit** and when conducted with **appropriate instruments**

Disposable income elasticity to GDP



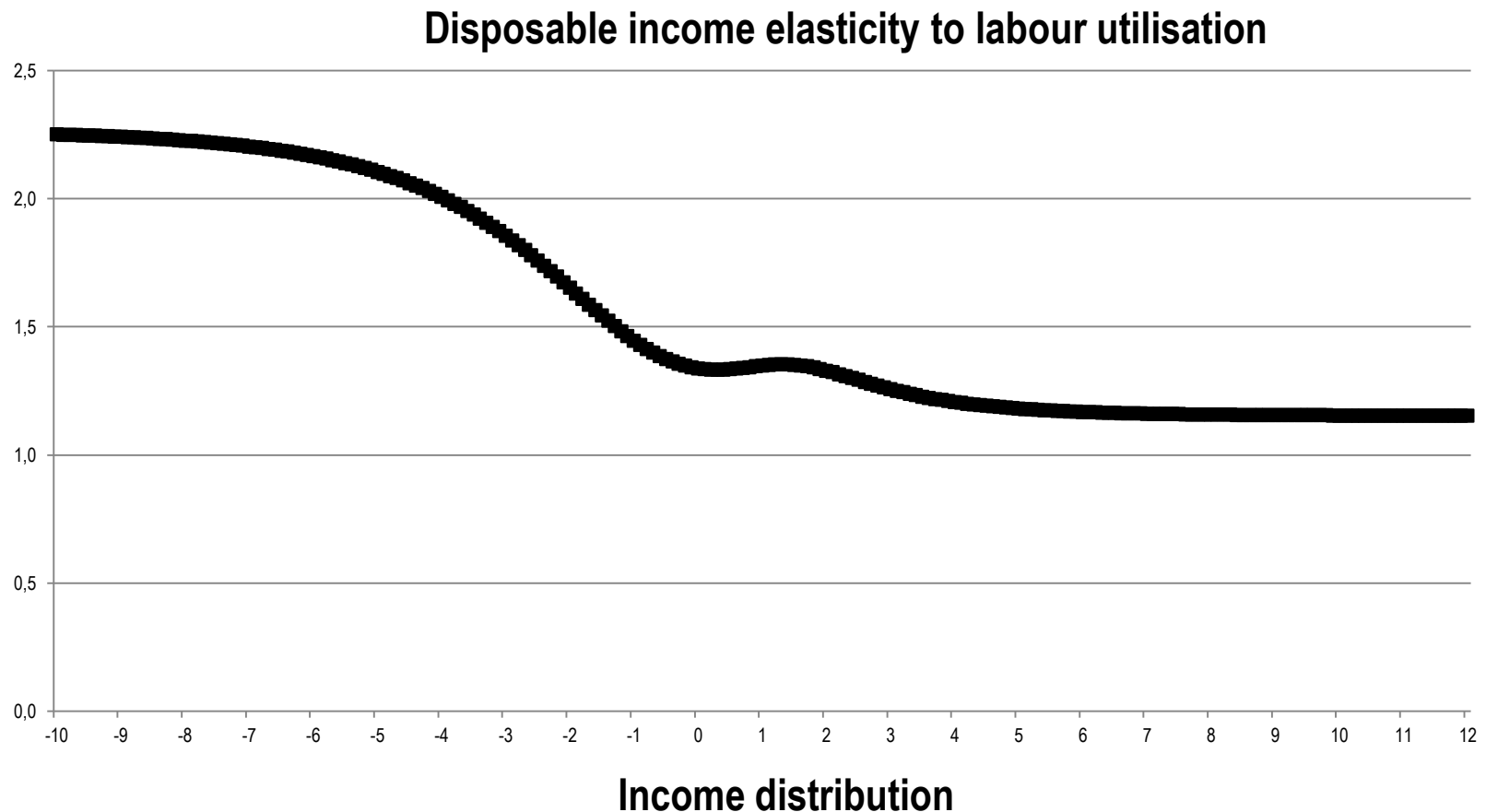
Are we necessarily growing unequal?

- Beware of the scale before drawing conclusions...



Are we necessarily growing unequal?

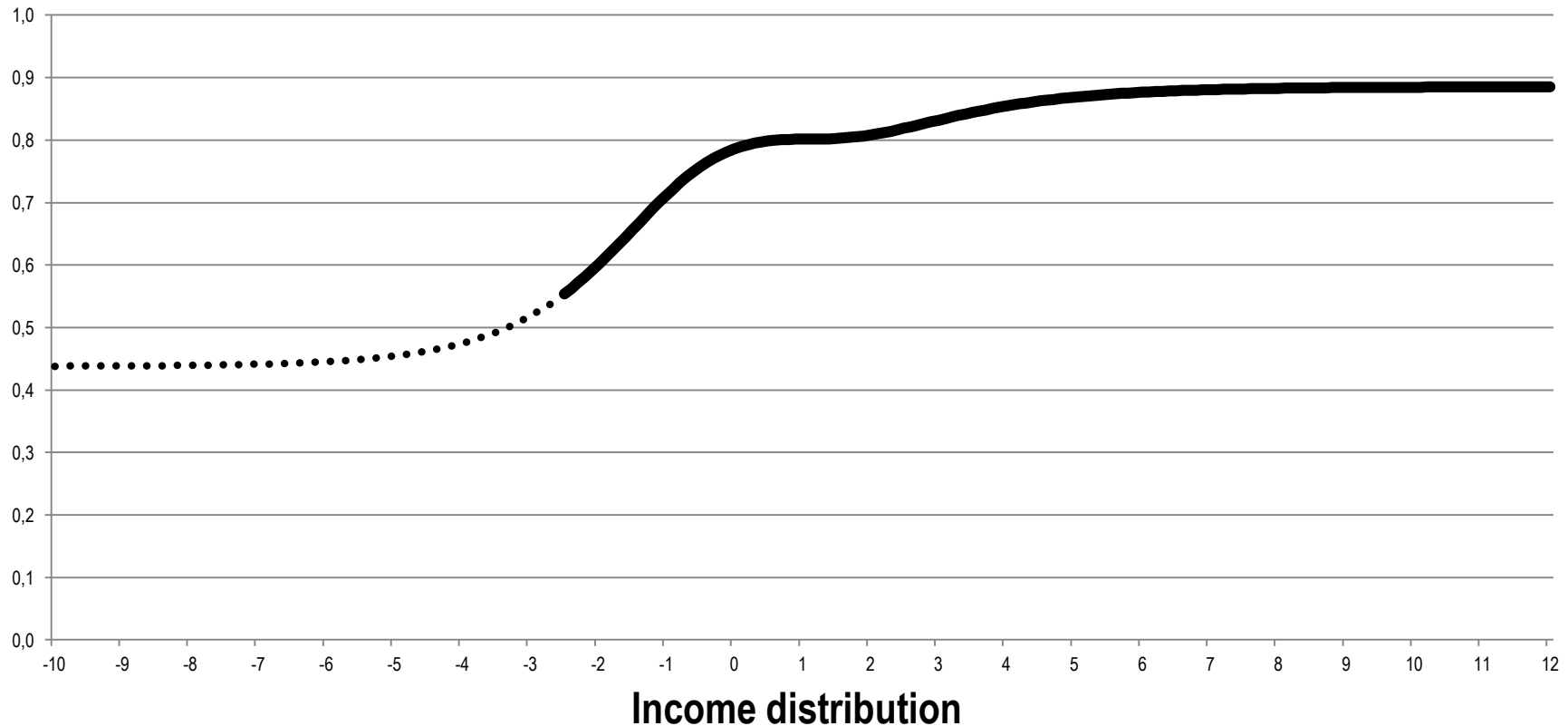
- The distributional effect of growth depends on **the sources of growth: job-rich** growth tends to be equalising



Are we necessarily growing unequal?

- However, productivity tends to be disequalizing : the bottom-part of the distribution is excluded from productivity gains

Disposable income elasticity to productivity

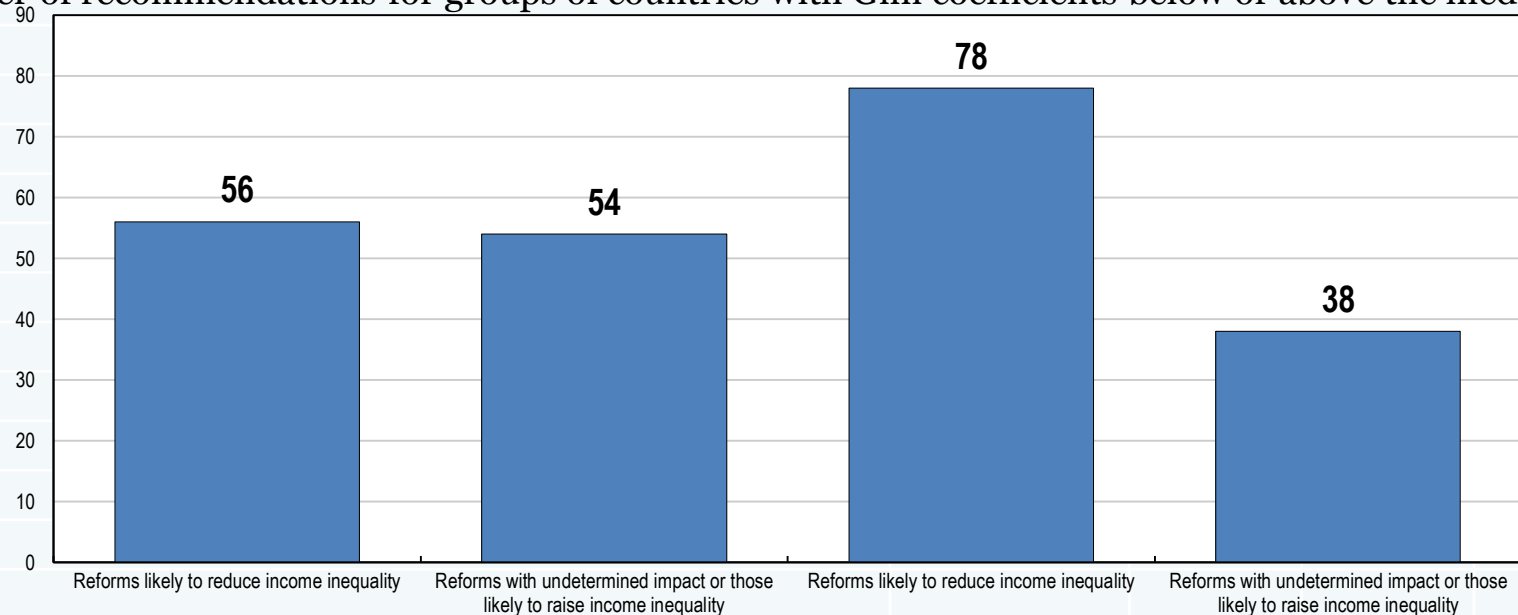


Are we necessarily growing unequal?

- As a result, pro-growth (especially labour utilisation-enhancing) reforms can enhance equality:

Many Going for Growth recommendations will help reducing household income dispersion

Number of recommendations for groups of countries with Gini coefficients below or above the median



Countries with Gini coefficient
below the median

Countries with Gini coefficient
above the median

Conclusion

- Inequality is a current ‘hot’ topic (Piketty...) but gauging when it is bad depends on a large number of factors
- **No simple trade-off:** despite the growing pressure “to do something” about inequality, policy makers should not undermine growth in the quest for greater equality
- **The world is complicated:** no simple recipe for enhancing equality while boosting growth. Finely tuned policies are necessary