



MINISTRY OF FINANCE

# Inequality and growth

Link, causality and policy issues

November 2015



# INEQUALITY AND GROWTH

## THE DEBATE HAS CHANGED

### OECD (2012)\*

“The empirical evidence on the impact of inequality on growth has been inconclusive thus far. De Dominicis *et al.* (2008) perform a meta-analysis of more than 400 estimates ...

They conclude that the evidence constitutes an empirical puzzle and that no general consensus has emerged so far ...

from a theoretical standpoint **the effect of inequality on growth is ambiguous** as different countervailing mechanisms might be at work **and causation may run the other way round.**”

### 3 years later...

### OECD (2015)\*\*

“... growing inequality is harmful for long-term economic growth...

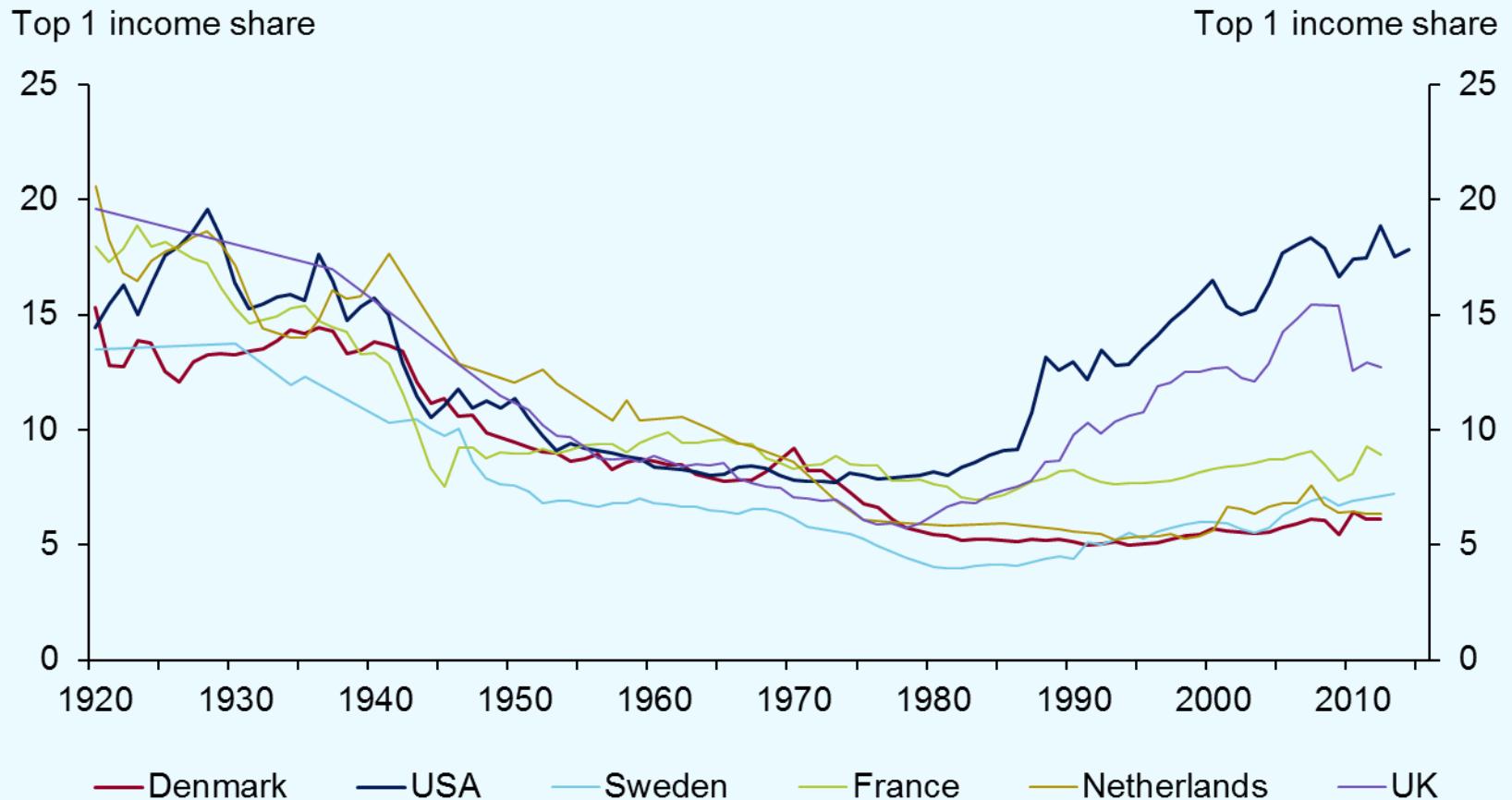
The rise of income inequality between 1985 and 2005 is estimated **to have knocked 4.7 percentage points off cumulative growth between 1990 and 2010...**”

\*) Less Income Inequality and More Growth – Are They Compatible? Part 1. Mapping Income Inequality Across the OECD, *OECD Economics Department Working Papers*, No. 924.

\*\*) In It Together: Why Less Inequality Benefits All, *OECD Publishing, Paris*.

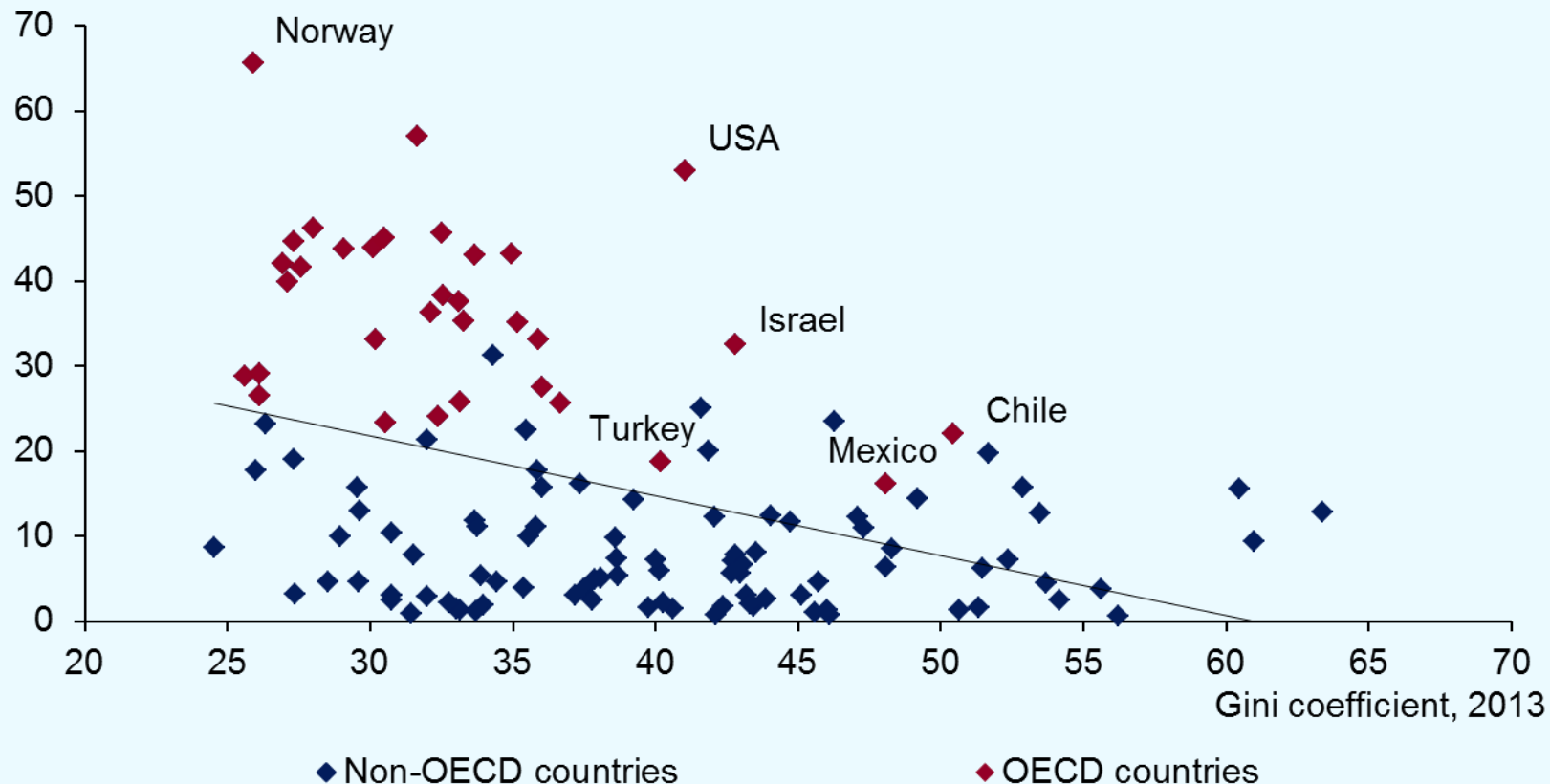
# NEW FOCUS FOLLOWS FROM DATA

## INCOME INEQUALITY HAS INCREASED THE LAST 30 YEARS



# THE CORRELATION BETWEEN INEQUALITY AND EFFICIENCY: INSTITUTIONS?

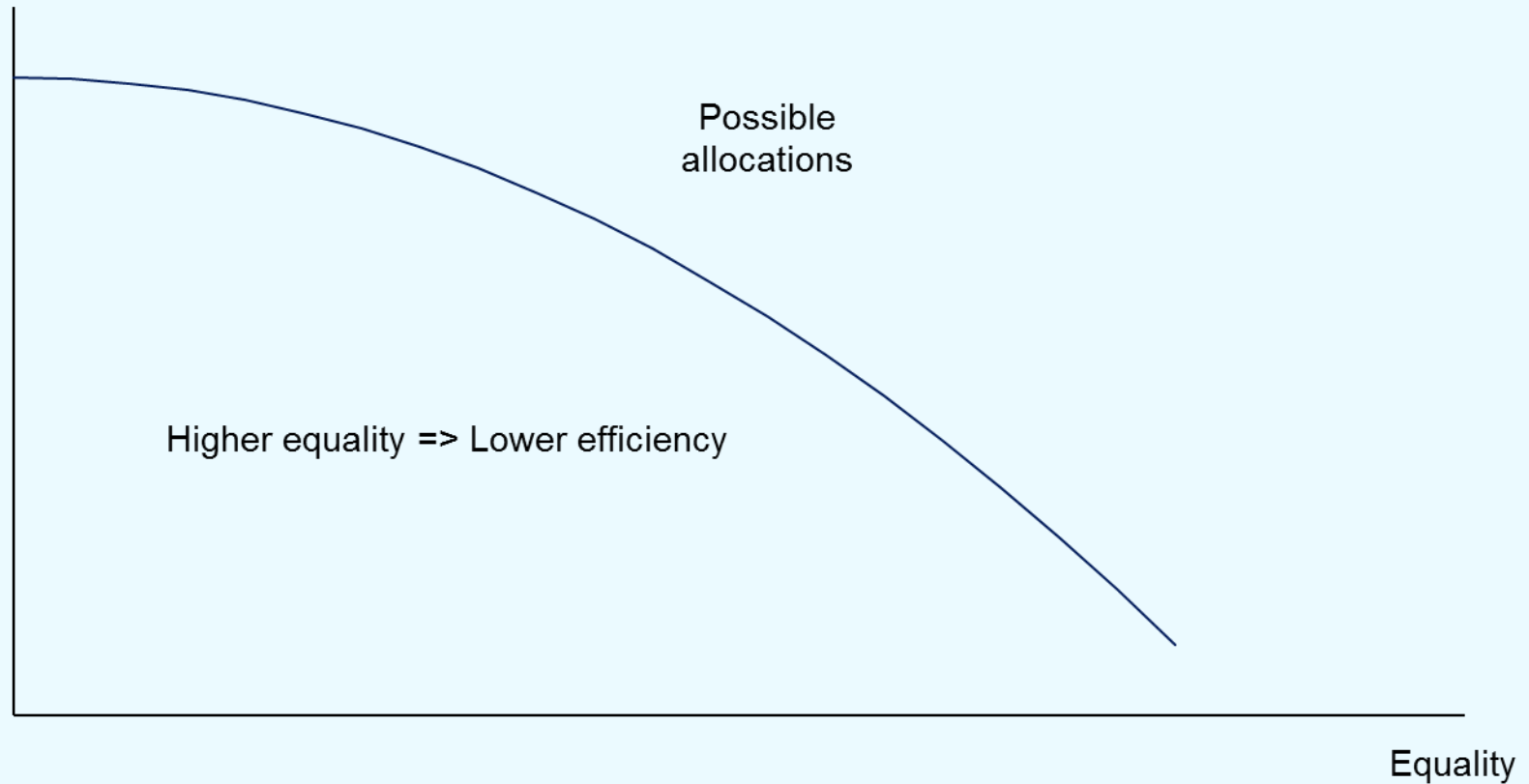
GDP per capita 2013, 1,000 USD PPP



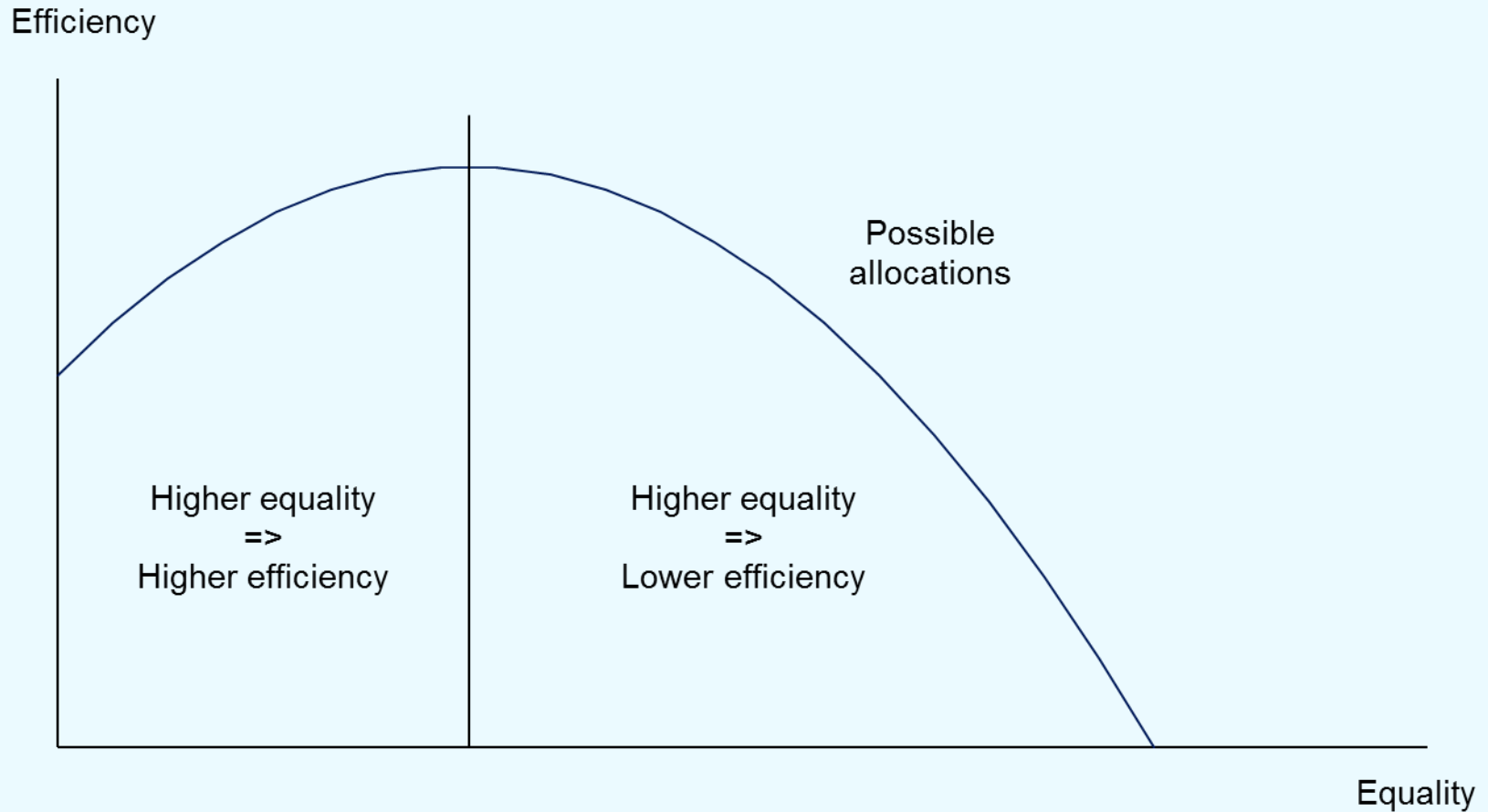
Source: World Bank and own calculations

# TEXTBOOK TRADE-OFF BETWEEN EQUALITY AND EFFICIENCY: THE COST OF EQUALITY

Efficiency



# A MORE GENERAL CASE: COST OF EQUALITY IS NOT NECESSARILY POSITIVE



# **INSTITUTIONAL FACTORS MAY REDUCE THE RISK OF LOW EFFICIENCY & LOW EQUALITY**

**Institutions that are likely to be main factors to insure a high level of human capital and cover some of the largest risk from risk taking include**

- Free access to public education
- Free health insurance
- Old age pension systems
- Access to unemployment benefits

**In countries with a developed set of institutions it is less likely that there exist large opportunities increasing equality for a positively sloped equality/efficiency frontier**

# MEASUREMENT OF EQUALITY INCLUDES ELEMENTS IN ADDITION TO DISPOSAL WAGE INCOME

**Inequality in equivalised disposable income is affected by:**

- Household formation
- negative and positive capital income
- choices such as taking an education or preference for leisure

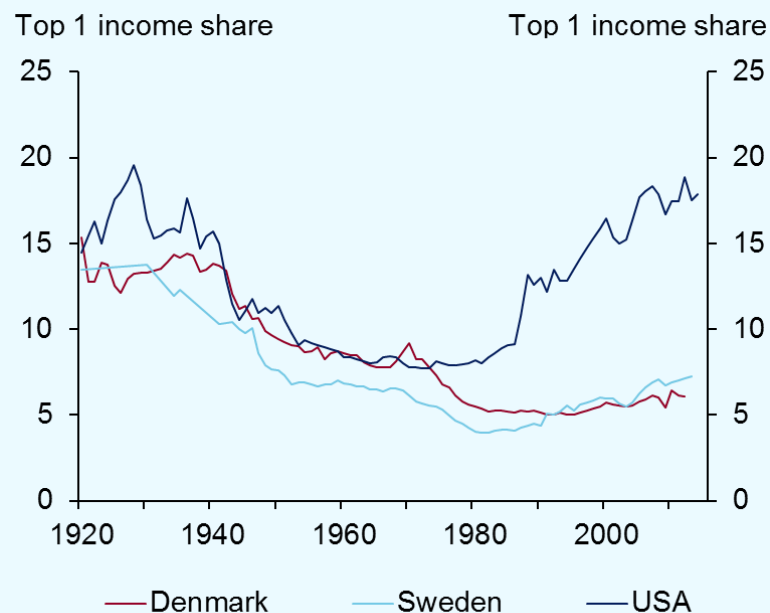
**Simply looking at equality in broad income categories is therefore likely to be a too composite measure of the impact on efficiency.**

**In addition publicly produced goods/services that are distributed either freely or with a large subsidy do not affect**



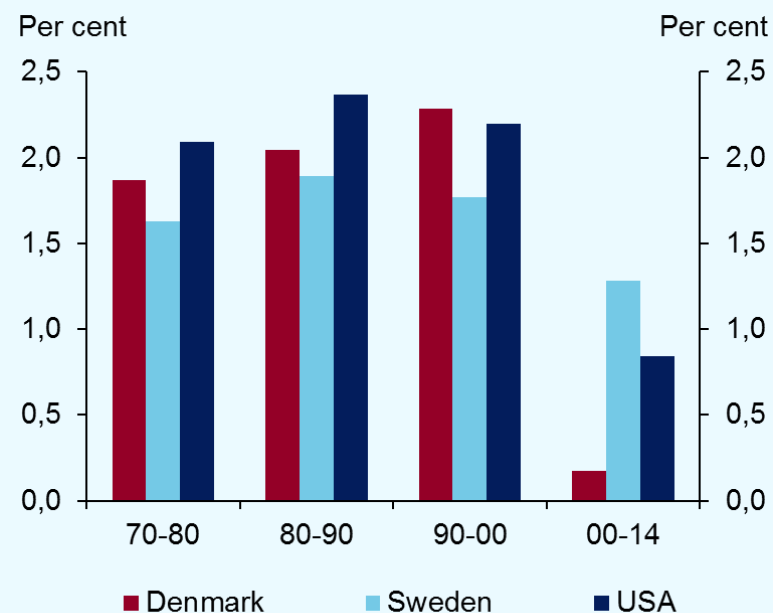
# IN DEVELOPED COUNTRIES THE CORRELATION IS LESS CLEAR

Development in top 1% income share



Source: World Top Income Database

Growth in GDP per capita since 1970



Source: OECD

# DRIVERS OF ECONOMIC GROWTH

## WHAT HAPPENED TO THE CONTROLS FOR INSTITUTIONS?

	OECD (2001)*	OECD (2015)**
Income inequality	Not include	-
Human capital (education)	+	Insignificant
Capital accumulation	+	Insignificant
Inflation variability	-	Not include
Trade exposure	+	Not include
R&D intensity	+	Not include
Financial development	+	Not include
Government size/financing	-	Not include
Convergence	Yes	(Insignificant)

\*) The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries, *OECD Economic Studies No. 33, 2001/II*

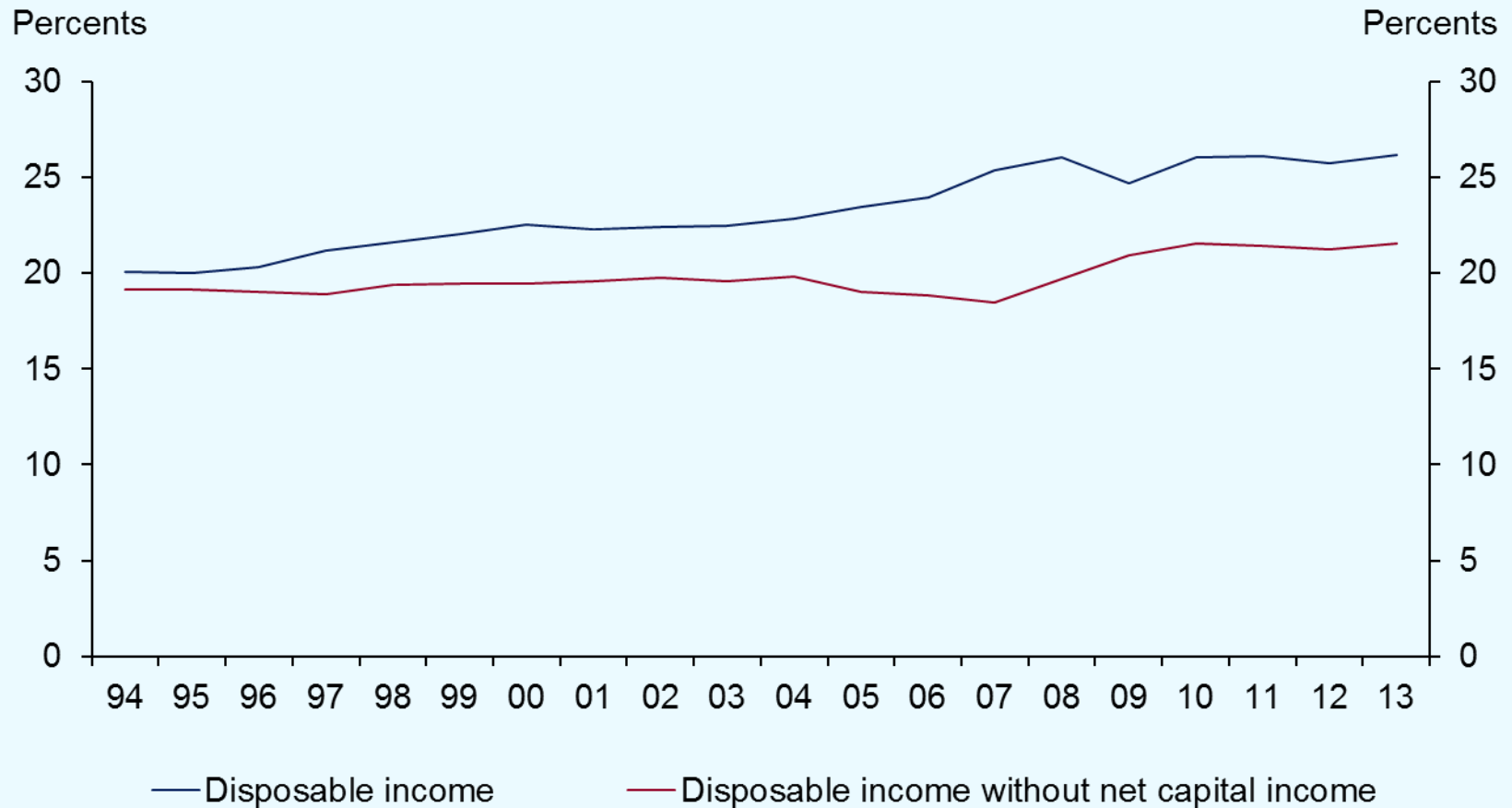
\*\*) In It Together: Why Less Inequality Benefits All, *OECD Publishing, Paris*.

# FOR A RANGE OF POLICY INSTRUMENTS THERE IS A TRADE-OFF

	Effect on growth	Effect on inequality
Early childhood development	+	+
Education	+/-	+/-
Integration of immigrants	+	+
Health services	+	+
Earned income tax credits	+	+
Lower top tax rates	+	-
Lower income transfers	+	-
Lower corporate taxation	+	-
Deregulation of markets	+	+/-
...		

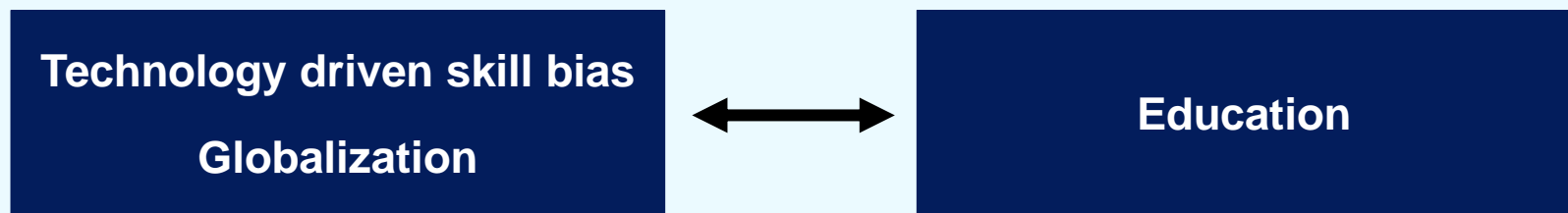
# RECAP OF THE DANISH EXPERIENCE

## RISING INEQUALITY IS MAINLY DRIVEN BY CAPITAL INCOME



# STATUS FOR DENMARK

The theory is often concerned with the “race” between:



These factors affect inequality through the labor market.

=> So far we have a “dead heat” in Denmark

# DOES THIS MEAN THAT WE SHOULD NOT BE CONCERNED?

**No**

**Increasing inequality is a concern for policy.**

- I would be worried if I came from the US treasury.

**But we need to better identify what driving the development in order to assess :**

- whether it constitutes a problem, and
- what the appropriate policy tools are.