OECD

POLICY BRIEF

Time to Act: Making Inclusive Growth Happen

Growing differently

We are at a critical crossroad. For years, we counted on economic growth as the only engine of prosperity, failing to realise that this model was leaving many behind; specifically the bottom 40%. In a context where global markets and increased connectivity of economic structures were skewed to benefit a minority of people and firms, disempowered citizens and communities called a halt.

This growth model failed us on three counts. First, by not preventing the crisis. Second, by not preventing the increased inequalities of income and opportunities. Third, by creating expectations of being better that have remained largely unfulfilled.

This model must be changed. It needs to get away from the mantra of growing the pie first, and distributing it later. It must become fair, people-centred and aspire to achieve multidimensional well-being.

Key Facts about Inequalities

- **Today the wealthiest 1% hold 19% of total wealth against just 3% held by the bottom 40%**
- **Children whose parents did not complete secondary school have only a 15% chance of making it to university - against a 60% chance for peers with at least one parent who had attained tertiary education**
- **Young men with a low educational degree can expect to live four years less than peers studying at university**

Don't just stand there, do something for Inclusive Growth today

- ***Strenghten the progressivity of the tax system, starting with capital tax reforms***
- ***Invest on early child development, with a focus on the households in the bottom 40%***
- ***Enhance dynamism in the business sector to the benefit of young firms and SMEs***

A moment ripe for action

The time to act is now. Everywhere we look the global order is being called into question and public trust in the institutions of government continues to plumb new lows - standing at just 42% in the OECD in 2016 **(Figure 1).** The origins of this loss of faith are numerous and vary considerably from country to country, but there is a common thread running throughout: a growing sense that the global economy is rigged to work in favour of the few and not the many and that governments are not able to respond to challenges that open trade raises.

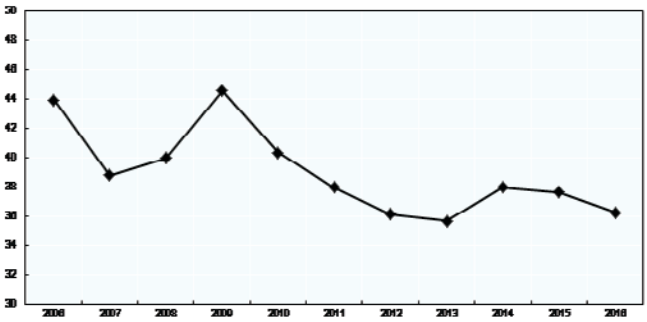
We have categorically failed to deal with this and the potential consequences of further inaction could scarcely be greater. For too long, the benefits of globalisation and rapid technological change have been interpreted within an overly simplistic economic framework; a framework that relied too heavily on averages - blurring differentiated outcomes for distinct income groups.

The digital revolution is raising additional challenges coming at fast pace, and demanding high skills and investments from people and firms. In the age of technology, the wide dispersion of productivity may bring further wage dispersion, and increased gaps between people, firms and regions. This without considering the fears of job automation and redundancy and risk that the ownership and management of big data may further exacerbate market power concentration.

The OECD's **Inclusive Growth Initiative** seeks to take these lessons on board. We need to move away from averages, to look at how policies impact different income groups, and focus on the bottom 40%. Acknowledge that inequalities - far from being just negative externalities - are central features of the way our economic systems function, we have attempted to examine how unequal outcomes feedback into our economies, shape people's aspirations and capabilities, productivity and opportunities at the micro level; and impact on growth and regional, national and international imbalances at the macro level.

Figure 1. Public trust in the institutions of government continues to plumb new lows

Percentage of the population reporting confidence in the national government, 2006-2016



Source: Gallup World Poll (2017). The OECD average is based on 29 countries, and it is population-weighted.

The OECD Inclusive Growth Initiative

The OECD has long highlighted the necessity of rethinking the traditional model of economic growth through the New Approaches to Economic Challenges Initiative (NAEC). This led to the launch of the Inclusive Growth Initiative in 2012 to put people's well-being centre-stage and develop a strategic policy agenda for feeding this new vision of growth.

This Initiative is led by Gabriela Ramos, Special Counsellor to the OECD Secretary General and Sherpa, and coordinated by Romina Boarini.

More information on the Inclusive Growth Initiative can be found at **www.oecd.org/inclusivegrowth**; and on NAEC at **www.oecd.org/naec**.

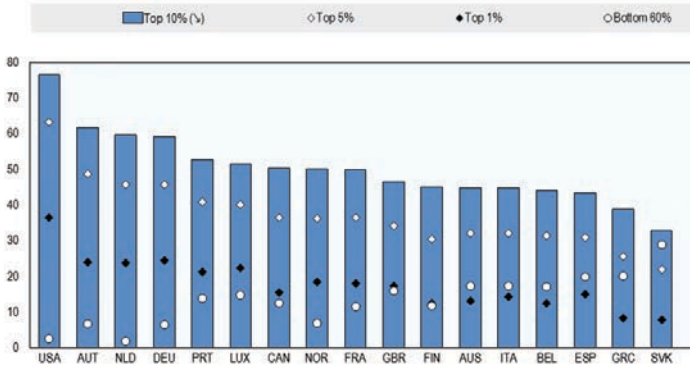
For more information please contact: Inclusivegrowth@oecd.org

Inequalities undermine our societies and hold back our economies

Our work has charted how, for over a generation, rising inequalities have been blighting people's lives, wasting their potential contribution to our societies, and chipping away at their faith in the ability of governments to make a difference. Today, the top 10% of the income distribution in OECD countries takes home more than ten times the income of the bottom 10%, up from just seven times in the mid-1980s. Looking at market incomes, we see that the rise in inequality has often been even greater over the past three decades, with those at the very top doing staggeringly well. The share of top-income recipients in total pre-tax income increased in most countries over the last three decades, as the top 1% captured a huge 47% of total growth in pre-tax incomes in the US, 37% in Canada and 20% in the UK. In short then, in a majority of OECD countries, those at the top have pulled away from those at the bottom.

Figure 2. The top 10% owns over half of all household wealth in the OECD

Wealth shares of top, middle and bottom of the net wealth distribution, 2010 or latest year



Source: OECD Wealth distribution dataset

There is also a strong regional component to the growing divide. Many OECD countries see large regional income splits, with big differences within countries between urban and rural areas. People living in cities earn on average 18% more than those living elsewhere, though differences in living costs might partially offset earning differences. There are also large differences among cities within countries.

The picture is even more troubling in terms of wealth. Tax data indicate that wealth inequality has grown over recent decades, with the richest 10% in the OECD coming to own around half of all household assets, whilst the bottom 40% owns barely 3%. At the very top of the distribution, the top 1% holds a staggering 19% of total wealth **(Figure 2).**

All too often, wealth and income inequality stand in a symbiotic relationship with the intangible social trappings of success, such as cultural capital and access to parental networks. Together, they influence the key formative outcomes in children's lives, such as the quantity and quality of education children can expect and their future labour market engagement, helping to turn the unequal outcomes of one generation into the unequal opportunities of the next.

OECD data show that the children of poorer parents struggle to keep up with the social and cultural capital of their wealthier class-mates. From that initial disadvantage, many go on to lower educational attainment with children whose parents did not complete secondary school having only a 15% chance of making it to university - against a 60% chance for peers with at least one parent who had attained tertiary education. More troubling still is the fact that the very same children at a disadvantage in the education system typically go on to receive smaller salaries and, most worryingly of all, to live shorter lives.

The rise in inequalities is deeply unjust, but it is also very corrosive from an economic perspective. It is not only those at the bottom who suffer when inequalities scale new heights – we all do. When the poorest are unable to fulfil their potential, we all lose out on the visionary leaders, the innovators, and the economic growth that could have come to pass.

Our work has shown that inequalities likely reduce aggregate productivity and growth because they reduce the capacity of the poorest 40% to invest in the education and skills of their children. That is not insignificant. Particularly for a world where, nine years on from the eruption of the financial crisis, many countries continue to find themselves stuck in a low growth trap.

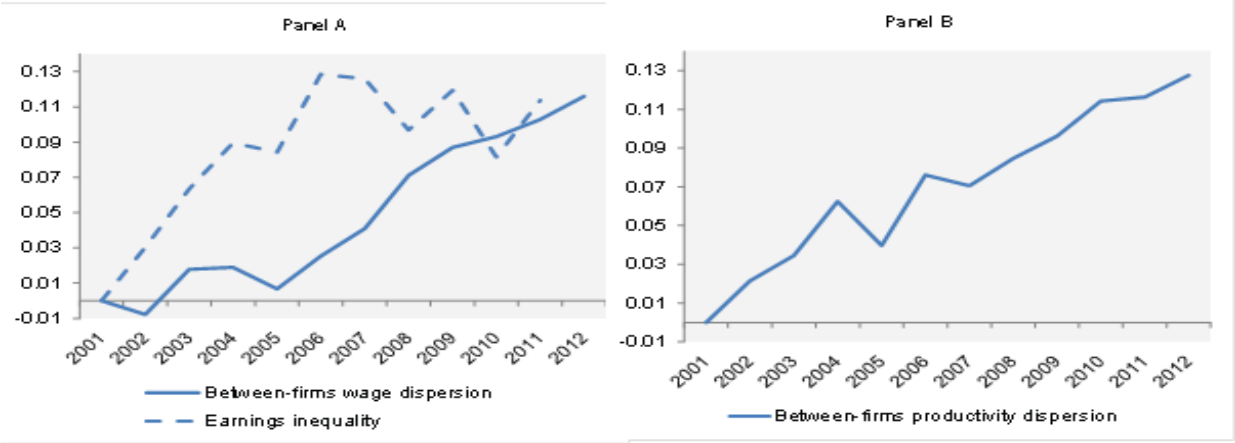
Even more troubling still, in most advanced countries, productivity growth remains painfully slow by recent historical standards. Our work on the Productivity-Inclusiveness Nexus spells out how this may be linked to the rise in inequalities. Leading firms - the so-called 'global frontier' firms - have continued to register strong productivity gains. These firms have marched ahead leaving the poorer performing counterparts struggling in their trail.

There are many possible factors that could explain this, one being that frontier firms are better-placed to lock-in superior productivity performance. Such frontier firms are typically larger, more profitable, have better access to financial leverage, are more likely to apply for patents than other firms and are often better-placed to rapidly diffuse and replicate cutting-edge ideas, technologies and business models. They commonly operate across different countries (typically as part of an MNE group), interconnected with suppliers and customers from different countries and are thus well-placed to take advantage of the gains from trade in global value chains, and greater international tax competition. This gives them a competitive advantage over their lagging counterparts, who have fallen behind, to enhance productivity and pay consistently higher wages to their staff **(Figure 3)**, which partly accounts for the growth of market income inequality. In sectors with high concentrations of Knowledge Based Capital and strong uptake in Information Communication Technologies, characterised by network externalities, frontier firms may even be benefiting from "winner takes all" dynamics through the accrual of rents.

With the ongoing global and technological transformation of our economies these issues are likely to be brought into starker relief. Digitalisation has the potential to unleash untold benefits for all of human kind, but if it is not managed properly, it could exacerbate inequalities by creating greater job insecurity, higher income inequalities and cementing 'winner takes all' dynamics in our most rapidly growing markets.

Figure 3. The growing productivity gap is mirrored by a growing wage gap

Wage and productivity dispersion over time within sectors and countries.



Note: The figure in panel A [B] plots the estimated year dummies of a regression of log-wage [productivity] dispersion (90th and 10th percentiles ratio) within country-sector pairs, using data from the following countries: AUS, AUT, BEL, CHL, DNK, FIN, FRA, HUN, ITA, JPN, NLD, NOR, NZL, SWE. The line referring to overall inequality plots the year fixed effects of a similar regression using the dispersion in earnings from the OECD Earnings Distribution database within each country. The data on overall inequality are only available at the country level and for a more limited set of countries: FIN, FRA, HUN, JPN, NOR, NZL for the whole period; AUS, ITA, SWE from 2002; and NLD between 2002 and 2010. Source: Berlingieri, Blanchenay and Criscuolo, 2017.

How can we begin to fix this?

This should give us all a sense of urgency. With the extent of the social and economic costs outlined, it is hardly surprising that rising inequalities have translated into growing political disaffection, anti-market sentiment and disenchantment with globalisation.

If we want to save openness and interconnectedness of people and places, we need to re-write the rules of the economic system to make them work for everyone. We also need to bring back fairness to the heart of the policy debate. The role of governments is key to this discussion. We need to redefine and reimagine theirs responsibilities, to ensure that they are set up to empower all people to contribute and make the most from economic growth. Governments must seek to prevent inequalities cascading down generations and recognise that its role is not simply to remove barriers to opportunities, but also to furnish people with the capacity to flourish. In practical terms, this will call for a re-orientation away from a risk-only approach to welfare provision, towards a lifelong enabling platform that provides individuals with capacity enhancing assets in the form of human and social capital, good health and active support in labour markets and build strong foundations for learning and adaptation for life and through life.

Policy Priority I: Re-design our tax systems to reduce inequality and promote inclusive growth

The design of tax systems can have important implications for inclusiveness and growth and should seek to support vulnerable groups. Progressive taxation is a key pillar of redistributive fiscal policy and has an important role to play in mitigating the advantages bestowed by inherited wealth and assets. The design of tax incentives also has important implications for how our economies grow and how the proceeds of that growth are shared out. A number of potential avenues are open to policy makers to gear tax systems for Inclusive Growth:

- *Enhance the progressivity of residential property taxation. Recurrent taxes on immovable property are comparatively simple to enforce and hard to avoid, and if designed well can fall mostly on high-wealth, high-income households. In many OECD countries property taxes can be designed to be more equitable and efficient.*
- *Strengthen inheritance and gift taxes. Inherited wealth is a significant factor contributing to the increase in intergenerational inequality, but taxes on inheritance have fallen in recent decades, from 0.25% of GDP in 1965 to 0.15% in 2014.*
- *Pursue capital tax reforms domestically to reduce rate differentials across asset types that distort savings decisions and incentivise tax planning.*
- *Bolster global governance of tax policy. MNCs capacity to engage in arbitrage between different tax jurisdictions exacerbates the trend in shifting the tax burden from capital to labour. Governments signing up to and implementing the OECD's framework on Base Erosion and Profit Shifting (BEPS) will help combat this.*

Policy Priority II: Focus on early childhood development

Efforts need to start with targeted early childhood development to help those cast adrift, at critical junctures in their lives. A set of policy interventions, focussed on tackling lifelong educational inequalities and on empowering individuals from disadvantaged backgrounds to climb the socio-economic ladder. In particular, the following actions are essential to promoting Inclusive Growth:

- *Remove barriers to early childhood education and care services (ECEC), which are still high in many OECD countries* ***(Figure 4)****.*
- *Provide opportunities to develop socio-emotional and cultural skills. Programmes such as Sure Start in the United Kingdom and the Seattle Social Development Project provide guidance on parenting style and enhance the relationship between parents and children. Participating children show more positive social behaviours, and greater independence and self-regulation than their peers who did not participate in the programme.*
- *Support evidence-based parenting programmes and home visits*

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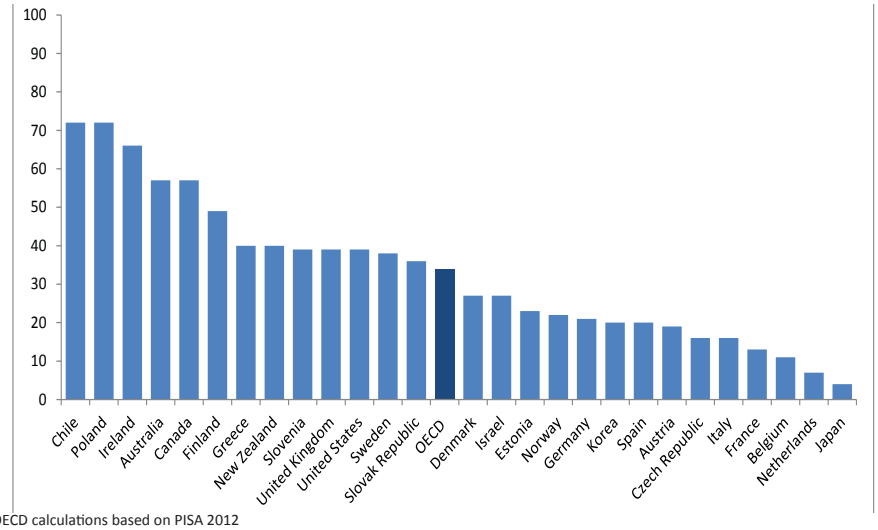
for disadvantaged families, can help families provide for their children and achieve their goals for child development.

- *Investing in lifelong learning and tertiary education is a critical area to both enhance social mobility and produce strong returns for the state. OECD research suggests that spending on skills yields substantial returns to governments in terms of personal income tax revenue as raising the skills of those on lower incomes raises their wages.*

Figure 4 Barriers to early child education and care services are still high for poor households

Percentage of children from low socio-economic background reporting up to one year of pre-primary education



Source: OECD calculations based on PISA 2012

Policy Priority III: Enhance dynamism in the business sector to the benefit of young firms and SMEs

If firms are to both support the pursuit of societal well-being and benefit from a prospering society, a profound reappraisal of the policy making process is required. This exercise should span an array of domains: from making financial markets work better as channels of capital to productive activities, to looking at the role of public policies for enabling and promoting innovation. In particular, focus should be given to the following initiatives:

- *Regulatory reforms that make it possible for young and small firms to enter marketplaces, thrive and exit smoothly: favourable access to finance, more lenient bankruptcy regulations, and stronger contract enforcement.*
- *Ensure that business taxes and subsidies provide a level playing field for all firms. For example, reducing tax compliance costs that fall most heavily on small and young firms through the use of digital technologies.*
- *Provide direct support and tax incentives for all firms to carry out R&D regardless of size.*
- *Re-think the patent system so that patent regimes do not incentivise rent-seeking amongst incumbent firms and become a significant obstacle to entry for younger firms.*

Inclusive Growth requires integrated policy packages: the measures above are just examples of important areas where policy-makers should focus their attention. High-quality jobs, gender equality in labour markets and preventive health policies are other important examples of inclusive growth policies that need to be considered when designing those comprehensive packages along with the measures highlighted above. Based on these recommendations, the OECD is helping countries develop context-sensitive solutions that could best respond to country-specific needs and starting conditions on inclusive growth.

Further reading

- OECD (2017), Bridging the Gap: Inclusive Growth 2017 Update Report
- OECD (2016), The Productivty-Inclusiveness Nexus: Preliminary version, OECD Publishing, Paris

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