New Approaches to Economic Challenges [B6]
Closing the loop: how inequality affects economic growth and social cohesion

THEME OF THE PROJECT

Economic theory suggests inequality can affect economic growth in ambiguous ways

With inequality increasing in most OECD countries over the last years, assessing its economic impact has clear policy relevance. Theoretically, inequality might affect economic growth in both positive and negative ways. On the one hand, larger income disparities generate an incentive to work harder, study longer, and take greater risks, all of which can lead to more economic activity and growth. In presence of borrowing constraints, however, more inequality means that the wealthy are better able to take advantage of economic opportunities than the poor. Poor children may be unable to spend as long in education, thereby harming their future earnings potential. Poor people may also find it difficult to invest in new opportunities. As a result, inequality acts as a drag on growth.

RESULTS OF THE WORK STREAM

Higher inequality can lower economic growth…

Econometric analyses based on new data for the OECD suggest that income inequality has a negative and statistically significant impact on subsequent (medium-term) growth. The evidence indicates that what matters most is the income gap between lower-income households and the average. The negative effect of inequality on growth is driven not just by the poorest income decile but actually by the bottom 40% of income earners. The analysis also provides little backing for the claim that redistributive policies result in lower economic growth, although, not all redistribution is necessarily equally good for growth.

..via the human capital accumulation channel…

The analysis evaluates one prominent channel through which inequality is supposed to affect growth: the human capital accumulation theory. According to this theory, inequality undermines education opportunities for disadvantaged individuals, lowering social mobility and slowing human capital accumulation. Analysis based on micro data from the Programme for the International Assessment of Adult Competencies (PIAAC) Survey shows that increased income disparities within countries depress skills development among individuals with poorer parental education backgrounds, both in terms of the quantity of education attained, and in terms of its quality (i.e. skill proficiency). Educational outcomes of individuals from richer backgrounds, however, are not affected by inequality.

NEW APPROACHES / POLICY IMPLICATIONS

Tracing the human capital channel through which inequality affects growth…

Income inequality undermines growth by limiting investment opportunities, particularly in education, for those at the bottom of the income distribution. By weakening skill-acquisition, inequality lowers a country's growth potential. Moreover, it creates a vicious circle where limited educational opportunities transform into limited job opportunities and low lifetime earnings which perpetuate income disparities lowering social mobility. The case for limiting or – ideally – reversing the long-run rise in inequality is not only that our societies will become less unfair, it is also that they will become richer and more mobile.

…can suggest appropriate "win-win" policies.

The policy strategy for tackling rising inequalities while promoting economic growth and social mobility requires a policy package). One policy avenue involves reforms to tax and benefit policies to prevent low-income households from falling further back in the income distribution, while maintaining the right incentives to work and invest. Another one requires improving access to public services, such as high-quality childcare and education and training, particularly by young and adult individuals from low-income groups, or access to health.

Promoting inclusive employment and access to public services will guarantee the "double dividend".

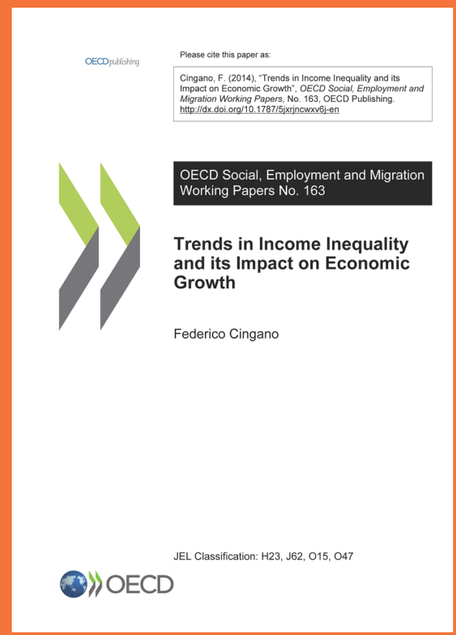
Another important element of the policy tool kit is active promotion of inclusive employment. Increasing employment can contribute to sustainable cuts in income inequality while promoting growth, provided that employment gains occur in jobs that offer career prospects. A key policy challenge therefore is to facilitate and encourage access to employment for under-represented groups, such as youths, older workers, women and migrants.

… as policies that enhance access to opportunities to youth and over the working life

Successful policies therefore need to take account of the fact that in unequal societies low socio-economic groups are likely to have underinvested in formal education. Accordingly, strategies to foster skills development should include improved job-related training and education for the low-skilled (on-the-job training) and better access to formal education over their working lives.

PROJECT PAPERS

- **Cingano, F. (2014),** "Trends in Income Inequality and its Impact on Economic Growth", OECD Social, Employment and Migration Working Papers, No. 163, OECD Publishing. http://dx.doi.org/10.1787/5jxrjncwxv6j-en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Trends in Income Inequality and its Impact on Economic Growth

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