

OECD ECONOMIC POLICY BRIEF

Pro-growth reforms: their impact on income inequality and household economic vulnerability

- In theory, pro-growth policy reforms could have positive or negative effects on income inequality, macroeconomic stability and household income variability.
- Comparing macroeconomic stability and household income variability, the variability at the household level is much larger than the instability of macroeconomic aggregates, such as GDP.
- The more unequal is the macroeconomic distribution of income, the more variable is household income and therefore the more vulnerable are households.
- Labour and product market reforms that promote macroeconomic growth generally reduce income inequality. But there are some exceptions.
- Reforms that boost growth by reducing the size or progressivity of taxes and social transfers risk exacerbating households' income vulnerability and inequality.
- In some heavily regulated countries, tentative reforms can increase household income vulnerability. In these countries a reform momentum trap exists, and bolder reforms are needed to make markets responsive enough to stabilise households' income and raise their wellbeing.
- Programmes that effectively train people for new skills and actively accompany them in their search for new jobs can deliver triple gains: growth, micro-level income stability and income equality.

How to improve growth in OECD countries?

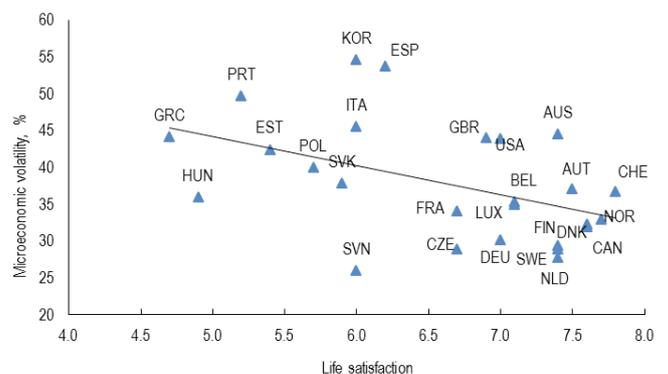
The answers are well known but governments often hesitate to implement them. Why is it so? Presumably because many people feel that pro-growth reforms, which often involve stronger competition, looser protection and higher job turnover increase their economic vulnerability and exacerbate inequalities. This policy brief brings together the key findings from new OECD studies about how economic policies influence the economic stability of households and income inequality. The studies are part of a wider OECD initiative on "New Approaches to Economic Challenges" (NAEC), which is an Organisation-wide reflection on the roots of and lessons from the global crisis, as well as an exercise to review and update the OECD's analytical framework.

Vulnerability to income volatility and economic inequality reduce well-being

People obviously care about how much they earn, but they also care about the stability of their employment and wages. Being vulnerable to losing one's job or losing income harms wellbeing. People report lower levels of satisfaction with life in countries where their income after paying taxes and receiving transfers is more unstable (Figure 1).

The vulnerability of individual households to income shocks is much larger than the instability of macroeconomic aggregates, such as GDP. In a typical year between 1994 and 2010, for one third of the households living in OECD countries, their disposable income changed by more than 30% relative to their income in the prior year. This reflects the many events that can generate large income changes for the household, especially due to changes in labour market participation: for instance, when one household member becomes unemployed, takes up a job, goes on unpaid parental leave, restarts work afterwards, goes part-time, retrains or stops working temporarily when the household moves to a different location. Many of these household-level changes offset each other, which explains why macroeconomic instability is considerably lower than microeconomic instability.

Figure 1. Life satisfaction is lower in countries where household-level income is more volatile

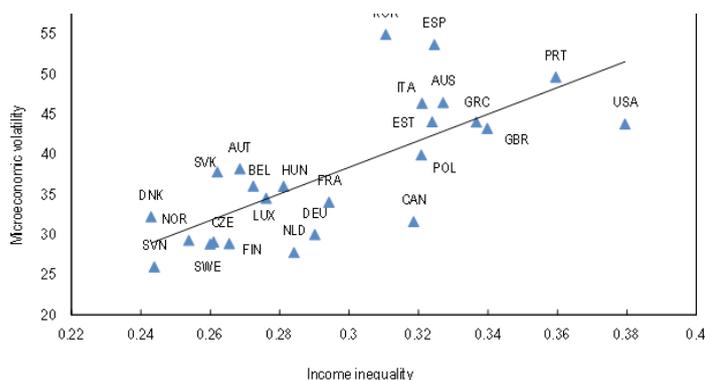


Note: Life satisfaction measures how people evaluate their life. Household-level income instability denotes the microeconomic volatility of disposable income. Source: Cournède, Garda, Hoeller and Ziemann (2015).

Contrary to public perceptions of increased vulnerability, fluctuations in household income show no generalised upward trend across OECD countries. On average across the eleven OECD countries for which this can be measured going back to the mid-nineties, household-level income volatility has even slightly declined. Only two countries have experienced meaningful increases (Luxembourg and the United Kingdom) while seven have experienced decreases (including France and Italy). Even during the crisis, where data is available for more countries but only up to 2010, changes in household-level economic volatility have generally been small. The only exceptions are Spain and the United Kingdom, where substantial increases in household income vulnerability reflect the significant rise in unemployment between 2007 and 2010.

Households' vulnerability to income volatility is generally greater in more unequal countries (Figure 2). Greater income inequality is also associated with lower levels of life satisfaction. The welfare effects of income instability and inequality thus often compound each other. Income inequality has been steadily widening in most OECD countries during the past decades. According to a traditional measure, the Gini coefficient, income inequality has risen by 3 percentage points on average across countries from the mid-1980s to the late 2000s. Furthermore, the ratio of the top-to-bottom income decile, another conventional metric, reached a three-decade high in 2010.

Figure 2. Household-level income instability is greater in more unequal countries



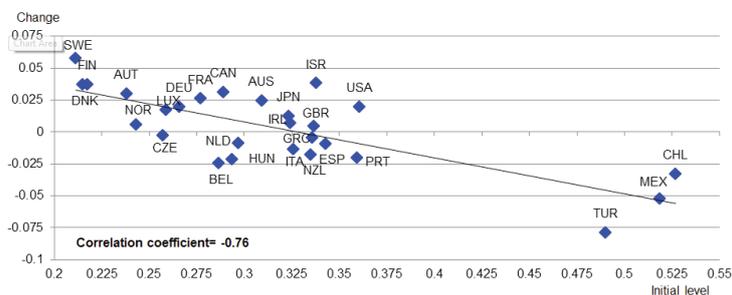
Note: Income inequality is measured by the Gini index of household disposable income. Household-level income instability denotes the microeconomic volatility of disposable income.

Source: Cournède, Garda, Hoeller and Ziemann (2015).

However, developments in income inequality have not been uniform across countries. In fact, between the mid-1990s and the late 2000s, OECD countries experienced “inequality convergence”: inequality in household disposable income has tended to fall in the most unequal countries and to rise in the most equal ones (Figure 3). The largest increases in inequality affected Sweden, Denmark and Finland, which nonetheless remain among the most egalitarian countries. The sharpest reductions occurred in Turkey, Mexico and Chile, which started from a high level of inequality.

Figure 3. OECD countries have experienced inequality convergence

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



Source: Causa, Araujo, Cavaciuti, Ruiz and Smidova (2014) based on the OECD Income Distribution Database.

Some pro-growth reforms entail trade-offs

Growth-enhancing reforms of taxes and public spending can raise trade-offs with both equality and stability of income. Measures to reduce the progressivity of taxes or transfers can boost growth by improving incentives to work and invest. However, such reforms are also likely to result in greater income inequality and more acute vulnerability of households to income fluctuations, because progressive taxes and transfers play an important role in redistributing income and smoothing large income shocks.

Reducing the generosity of unemployment benefits may raise employment by encouraging the unemployed to intensify job search. However, higher economic efficiency may come at the cost of higher household-level economic instability, because unemployment insurance strongly attenuates the income impact of losing one’s job. Unemployment benefit reforms do not necessarily increase income inequality: to the extent that the labour incentive effect is strong enough, income inequality can even decline thanks to higher employment. Nonetheless, in such reforms, the long-term unemployed need special attention. Because they face bleaker employment

prospects, tightening their benefits can increase inequality and poverty unless matched by other forms of social protection or targeted requalification measures.

Incremental pro-growth reforms of tightly regulated labour and product markets can raise policy trade-offs: they generally improve growth and income equality but exacerbate household income vulnerability. Relaxing labour market regulations delivers higher income equality if it reduces labour market duality, which can be achieved by narrowing the protection gap between temporary and regular contracts while ensuring adequate unemployment benefits. Lowering regulatory barriers to product market competition can also improve income equality, as the positive effect from higher employment can more than offset the negative effect from higher wage dispersion. However, when starting from tight levels of regulation, easing constraints on lay-offs or competition often results in greater economic instability for households.

These trade-offs can sometimes be overcome by being bold enough

Ambitious rather than incremental action can avoid trading off higher growth and better income equality against greater vulnerability to income shocks when reforming tightly regulated economies. Reforms that replace highly restrictive regulations of labour and product markets with pro-competitive policies improve income stability for households. More rapid adjustments from job to job mitigate household earnings fluctuations.

Countries that enforce tight restrictions therefore face what can be called a “marginal-reform trap”. Modest moves towards deregulation would tend to be associated with greater volatility of employment and income for households, while deeper reforms would reduce this volatility.

Some pro-growth reforms have positive effects for stability and equality

Stepping-up job-search support and activation programmes for the unemployed can promote income equality and household-level economic stability. Associated reforms raise employment opportunities for less-skilled workers and have little deleterious effect on wage dispersion, thus leading to lower income inequality. At the same time, effective active labour market and training programmes generally increase micro-level income stability by improving job matching and reducing unnecessary worker reallocation. As a result, these reforms can deliver triple gains: efficiency, micro-level income stability and income equality.

Papers providing background to this note:

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, No. 1180, OECD Publishing, Paris.

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Cournède, B., P. Garda, P. Hoeller and V. Ziemann (2015), “Effects of Pro-Growth Policies on the Economic Stability of Firms, Workers and Households”, OECD Economic Policy Papers, No. 12, OECD Publishing, Paris.

Cournède, B., P. Garda, and V. Ziemann (2015), “Effects of Economic Policies on Microeconomic Stability”, OECD Economics Department Working Papers, No. 1201, OECD Publishing, Paris.

Garda, P. and V. Ziemann (2014), “Economic Policies and Microeconomic Stability: A Literature Review and Some Empirics”, OECD Economics Department Working Papers, No. 1115, OECD Publishing, Paris.

OECD (2015a), “Do Policies that Boost Aggregate Growth Generate Economic Instability for Individuals?”, OECD Economics Department Policy Notes, No. 25, April 2015.

OECD (2015b), “Growth and Income Inequality: Trends and Policy Implications,” OECD Economics Department Policy Notes, No. 26, April 2015.