A FISCAL APPROACH FOR INCLUSIVE GROWTH IN G7 COUNTRIES
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Globalisation and technological changes are transforming the way our economies function, creating tremendous opportunities for growth but also risks that the gains of prosperity may not be distributed evenly within countries. Economies increasingly operate on a global scale, with capital and high-skilled labour roaming freely across the globe, partly as a result of intensive technological change, and particularly digitalisation, which reduce mobility costs and open the access to new business opportunities. Global trade has significantly contributed to raise living standards in both advanced and emerging economies, as well as in reducing income disparities between countries. However, globalisation has also gone hand in hand with higher domestic inequalities to the extent it has accelerated skill-biased technological change, the exposure to international competition, the global integration of domestic labour markets and the transmission of the financial and economic crises that have all contributed to lower income growth for the poorest and, in a few G7 economies, for middle classes as well. In some cases, a change in policy settings, in particular in the area of tax and transfers, has contributed to exacerbate the impact of globalisation on inequalities.

In response to those profound changes, governments should develop new policies to help all citizens make the most of globalisation and digitalisation opportunities and better withstand related risks. Policy-makers can ensure that the new forces that are shaping prosperity at the global and local levels operate in a sustainable fashion, enabling individuals and companies that have been left behind to catch-up and play an active role in the creation of future wealth and well-being. To this aim, governments can upgrade and redesign a range of policy settings that matter to income and wealth creation and distribution, taking into account the borderless nature of our economies and societies, as well as their deep structural transformations induced by digitalisation and other mega trends.

Inclusive growth provides a framework for better understanding the distributive challenges of borderless economies and, more importantly, for overcoming successfully those challenges highlighting the mechanisms through which policies can ensure that economic prosperity is shared more fairly. This report starts from the analysis of two major critical trends in G7 countries and beyond, and namely: (a) the rise and/or high level of inequalities and (b) stagnating productivity growth. The OECD has developed an original, powerful analysis of the nexus between productivity and inclusiveness. This analysis suggests that promoting inclusiveness is key to stronger and more sustainable productivity growth and, conversely, that a dynamic environment for business and innovation is a pre-condition for reducing inequality and opportunity gaps.

Fiscal policy has a potential to affect the nexus between productivity and inclusiveness in a fundamental way. Numerous fiscal policy instruments exist to make the relationship between a productive and inclusive economic environment a mutually enhancing one. These include allocating public resources to programmes and services that have the potential to influence productive capabilities of individuals, economies and societies; protecting individuals from disruptive changes and helping them to be resilient and manage those changes effectively; and influencing individuals and companies’ investment decisions through tax policy and public transfers.

The OECD is committed to help G7 countries to implement Inclusive Growth strategies through a variety of innovative tools. The OECD has long worked on understanding the causes and consequences of inequalities in G7 economies and other countries and has identified numerous policy solutions that G7 economies could implement to foster inclusive growth. The Organisation launched in 2012 its Inclusive Growth Initiative to assess the largest drivers of inequalities and to understand how economic growth can translate in greater well-being for all. This knowledge has also been enriched by the development of
various platforms that engage with a number of stakeholders, including business, local governments, civil society and citizens on the issue of Inclusive Growth. This report builds on the results of the OECD Inclusive Growth Initiative.

**Rising inequality: what is the evidence and why does it matter?**

**G7 countries have been facing a prolonged period of low growth and persistent slower income growth of the poorest.** Evidence suggests that inequalities widened over the last two decades amid stagnating productivity growth and that, to some extent, these trends are mutually reinforcing. Today the top 10% of the income distribution in OECD countries take home 9.4 times the income of the bottom 10%, up from just 7 in the 80s. Rising inequality in G7 countries has, in large part, been down to richer households pulling away from their middle and lower income peers, a trend often exacerbated by the crisis but observed during the economic recovery as well. Wealth is much more unequally distributed than income, as the richest 10% of households in the OECD possesses half of total wealth, while the bottom 40% own just 3%. At the very extreme of the distribution, the top 1%, holds nearly 20% of total wealth. Finally, in recent years broadly defined living standards have stagnated or declined for the poorest and the median households in several G7 economies.

Inequalities also loom large at the subnational level, the strongest spatial income disparities being observed between urban and rural areas and among cities of different size. People living in cities earn on average 18% more than those living elsewhere, income inequality is higher in cities and tends to be higher in the largest cities. Regional disparities are higher when considering multidimensional welfare than when considering household income only. Disparities exist not only in the levels of welfare, but also in how welfare has evolved over time.

Rising inequalities are acting to lock in opportunity, privilege and exclusion, undermining intergenerational social mobility, putting stress on social cohesion and creating questions about the legitimacy of existing social contracts and institutions. Multidimensional inequalities often tend to accumulate and self-perpetuate from one generation to the next, making it harder for disadvantaged children to climb the socio-economic ladder and perpetuating a vicious cycle. On average, in the G7, children with lower-educated parents have just a 15% chance of attaining tertiary education, set against 63% for children whose at least one parent had attained tertiary education. As a result, social mobility is low in many of the G7 economies. These trends are feeding a growing disconnect between citizens and public institutions, with trust, the glue that binds our societies together, plummeting to record lows: faith in governments in the G7 hit 36% in 2016.

The report highlights that, while fiscal redistribution has been sizeable in G7 economies, many tax and benefit systems did become less redistributive over the past twenty years. In the first part of this period, cuts to benefits levels, tightening of eligibility rules to subsidies and the rising share of non-standard labour contracts that are not covered by social protection systems are among the factors behind weaker redistribution. Softening automatic stabilisers and fiscal consolidation measures in response to growing public debt from 2010 onwards account for the smaller redistributive power of fiscal policy observed in more recent years.

A wide range of factors have contributed to rising market income inequalities, including technological change, economic globalisation, financialisation and various other structural changes in labour and product markets. Rising wage dispersion in G7 has been associated with increased productivity differentials across firms and sectors, with skill-biased technological change as a key driver. At the same time, frontier firms have been better placed to lock-in superior productivity performance, which has translated among others in larger wages paid to their employees, accounting for part of the increased
earnings inequality across firms. Financialisation has also exacerbated income inequality in OECD countries through the strong expansion of private credit and stock market of the last thirty years as well as through extremely large wage premia paid to workers in the financial sector. Globalisation also increased governments’ difficulty in taxing mobile capital income, resulting in a tendency to use taxes on less mobile bases to finance government expenditures.

Rising inequality is also a major source of concern because of its potential impact on productivity and growth and on public finances. Higher income inequality constrains the ability of low-income groups to contribute to economic growth, hindering their ability to invest in quality education and skills throughout their lives and that of their children. Unequal countries also do show larger skill mismatch, with significant negative effects on productivity. Large inequalities jeopardise future growth and productivity potential through low labour force participation, low employability and marginal attachment to the labour market.

Rising inequalities pile further pressure on public social budgets, as it implies greater demand for in-work benefits and may result in larger joblessness if affecting future employability of children. In several G7 countries redistributive policies have mitigated the impact of productivity differential across regions and sectors as well as partly compensated excessive market income inequalities. While these policies are effective in reducing gaps in market outcomes, they should also effectively translate in reducing gaps in opportunities. In particular, it will be important that the social protection and the tax and benefit systems are designed in a way that provides incentives and opportunities to individuals and firms to participate actively in the labour market as well as to invest in reskilling and upskilling to improve output potential and future productivity growth. More fundamentally, it is critical to understand the causes of inequalities and identify policy responses that can tackle directly those causes.

Potential policy responses: The role of pro-inclusive growth fiscal policy and structural reforms

Against this background, fiscal policy can become a key lever for ensuring that the benefits of globalisation and technological change are shared broadly. The design of fiscal policy can ensure that this is done in a manner which improves all citizens’ well-being and access to opportunity, levels the playing field for individuals, firms and regions to fulfil their productive potential, and ultimately drives stronger growth. In this context, fiscal policy and broader structural economic policies can be geared to promote stronger and more inclusive growth as part of a renewed social contract, tailored to individual national specificities, between the state, enterprise, and individuals.

In particular, two complementary and mutually-reinforcing strategies can be pursued. First, tax-and-transfer programmes could be recalibrated from an inclusive growth perspective to counter the steady decline in the redistributive effect of tax and benefit systems that is not due to other inevitable structural changes such as ageing. Second, G7 countries could accompany these pro-inclusive growth fiscal policies through balanced “packages” of structural policies to create an enabling environment for broad-based growth and reduce (ex ante and ex post) income inequalities.

Fostering pro-inclusive growth tax-and transfer systems

Some G7 countries need to strengthen the overall progressivity of the tax and transfers system while taking into account mobility of high-income earners as well as tax avoidance. To make the tax system both fairer and more growth friendly, G7 countries need to address the observed decline in the effectiveness of personal income taxes and cash transfers in reducing inequality in the cases where overall progressivity has become low and/or diminished significantly. Depending on the current levels of personal income taxes, countries may need to raise marginal tax rates and lower taxes for low-skilled workers (including through earned-income tax credits) in case there is still leeway in that direction. In reforming personal income taxes, countries need to counter the risks associated with the mobility of
high-income earners as well as tax avoidance. Transfer systems need also to become more progressive, typically by increasing the access to a number of schemes and their generosity in selected cases.

**Stronger progressivity of taxation could also be achieved by increasing effectiveness of capital income taxation and by broadening tax bases.** In addition, the potential of other taxes on wealth and property could be further explored. Countries need to consider the scope to increase the effectiveness of taxation of capital income at the individual level, noting the new capacity to do so with a global standard on automatic exchange of financial account information. Increases in the effectiveness of capital taxation could come through the taxation of certain forms of income, such as capital gains, which are exempt or heavily shielded from taxation, and by removing distortive tax expenditures and reducing rate differentials across asset categories, such as dividends, interest, housing rents, and private pensions; policy-makers should also broaden tax bases by revisiting/reducing/removing inefficient tax expenditures that disproportionally benefit those on higher incomes, including certain income tax expenditures and poorly targeted indirect tax expenditures. It is also important to explore the potential of other taxes in relation to country-specific circumstances, including taxes inheritance, immovable property and land taxes. Finally, countries may consider further developing income and wealth testing of tax provisions and transfers.

**G7 countries may consider shifting part of the financing of social programmes to general tax revenue instead of taxes on labour and social security contributions.** Such a shift has the potential to raise labour market participation, reduce labour market duality and boost labour productivity and economic growth, while at the same time extending welfare support to a larger fraction of society, in particular by covering atypical employment. In addition, where social security contributions are relied upon, their progressivity could be strengthened in order to limit their impact on low-income and low-skilled workers.

**International cooperation is key to responding to increased levels of capital mobility and addressing the increased use of offshore jurisdictions as a means to shelter income and assets offshore.** This includes continued implementation of Automatic Exchange of Financial Account Information for Tax Purposes (AEOI) and the strengthening of the network of information exchange agreements, the strengthening of beneficial ownership standards and their enforcement, and the implementation of the VAT/GST Guidelines and the recommendations of the OECD/G20 BEPS project. These are major instruments to reduce avoidance and evasion opportunities, strengthen the tax base and increase the effectiveness of international taxation in general and capital income taxation in particular.

**G7 governments may also want to revisit the tax and benefits system to provide enhanced incentives for labour market participation, encourage the creation of quality jobs in the formal economy, and provide incentives for skills development and lifelong learning.** Some of these incentives include reforming spousal allowances, targeting tax concessions toward second earners and levying personal income taxes on an individual basis; complementary measures to incentivise individual and business investment in skills; preventing tax- and benefit-induced incentives for early retirement; and improved tax compliance and enforcement with incentives to formalise. Those measures may also have net positive effects from a fiscal perspective and are therefore particularly appropriate.

**Social protection systems need to be adapted to respond and make the most of mega trends such as population ageing, borderless economies and digitalisation and new forms of work.** In an interconnected world, economies become more vulnerable to external shocks. Moreover, the growing importance of platform economies and non-standard forms of work may lead to the exclusion of an increased share of the workforce from traditional social protection programmes. To successfully overcome these challenges and reap the benefits offered by digitalisation and trade integration, countries need to strengthen automatic stabilisers and the counter-cyclicality of social policies and social
investment by creating the necessary fiscal space during upswings, providing more effective income and re-employment support to all affected workers in downturns; they need to strengthen the targeting and efficiency of social protection systems while adapting to the challenge of protecting non-standard workers; finally, pension systems need to be adapted to the new realities of ageing populations.

**Public spending for policies that have the potential to foster inclusive growth should be prioritised.** Those items include youth guarantees, childcare, education and long-life learning for the most disadvantaged individuals and areas, including with provision of a wide range of skills that matter in economies and societies of tomorrow, address health inequalities, promote access to affordable housing and optimise spatially-targeted fiscal expenditures.

**G7 countries should make childcare accessible, of high quality and affordable and ensure that seamless support is provided over the children’s lifecycle.** High-quality and affordable childcare increases female employment rates and reduces overall inequality as families become less vulnerable to job loss. Priority should be given to the 0-4 year cohort while adopting an effective approach to target those in socio-economic disadvantage, including migrants, to give them a better start in education.

The quality of teaching in deprived areas needs to be boosted, through incentives to attract the best teachers to the poor-performance schools, and investment in the physical quality of the educational infrastructure. Finance Ministers can work with Education Ministers to develop the incentives to use public funds in a way that ensures high quality education for all, but that puts high priority in kids from disadvantaged areas. In addition, a concerted effort involving central and local governments as well as employers and workers’ representatives is needed to foster adult learning and training programmes and address disparities in access and quality between high and low-skilled workers.

**G7 governments should ensure that programmes aimed at promoting a quick transition from school to work are well targeted and funded, with a special attention to disadvantaged youth.** Ineffective school-to-work transitions reduce potential growth and increase intra- and intergenerational inequalities. Many G7 countries have committed to give all youth access to different types of employment and training programmes if they do not find a job, but several EU countries are struggling to finance the Youth Guarantee and more generally the specific programmes under the guarantee are often not of high quality.

With an ageing population and rapid technological changes, health systems should be adapted to focus more on prevention, primary care and to patients with complex needs, while also making sure access to quality care and in particular often expensive specialised treatments is guaranteed. A particular focus should be put on reducing health inequalities, with prevention policies possibly playing the greatest role if specifically designed to reach the most disadvantaged individuals. Fiscal measures at deterring risky health behaviours, for instances taxes on alcohol and tobacco, can also be cost-effective solutions.

**Access to affordable housing should be promoted via a range of policies: investment in affordable housing stock, including social housing, housing benefits and better coordination between local, regional and central levels of government tasked with housing policy.** Concerted efforts, including through support to individual skills acquisition, to promote broader economic development in distressed regions are necessary in countries characterised by large regional disparities. Efforts supporting regional economic development can break the cycle of economic decline and deprivation. Government action should focus on supporting lagging regions in finding new sources of growth – shifting regional development policies from subsidies to investments, focusing in particular on transport infrastructure as well as spatially-targeted business development policies.
Promoting inclusive growth through balanced packages of structural policies

The benefits of a new fiscal approach for Inclusive Growth will be greater if governments implement balanced packages of structural policies at the same time. Fiscal policy affects resources distribution and shapes a wide range of economic incentives. For these decisions to be highly effective in stimulating a pro-inclusive growth environment, good framework conditions are essential. From this perspective, governments can adopt coherent packages of structural policies that include less stringent product competition, reduced labour market duality, more efficient innovation and infrastructural policies, a stronger rule of law and a more efficient public administration.

Conversely, the promotion of structural reforms may in some cases create the need for fiscal policy readjustments that internalise distributional costs. Some of the policies that are good from the perspective of spurring productivity growth, for instance more intensive competition, lower barriers to firms’ entry and exit, may also induce reallocation of capital and other resources that, while imply higher average labour productivity growth, entail displacement and other restructuring cost. Under these circumstances, fiscal policy can help to compensate those negatively affected by these reforms as well as support them making the transition towards new productive opportunities.

G7 countries should address the widespread decline in the pace of business creation and business dynamism as well as it potential causes, including the slowing pace of technological diffusion from leading to lagging firms and a decline in competitive pressure and market contestability. In order to reduce wage and productivity dispersion across firms, structural policies should aim at promoting market competition and levelling the playing field, including by correcting certain aspects of business taxation and subsidy systems. Countries should also address remaining obstacles to FDI, including differential treatment of foreign suppliers with respect to public procurement, taxes and subsidies or entry regulation as well as behind-the-border complications; and encourage domestic firms to adopt and adapt to new and advanced technology through policies that promote synergic investments in R&D, skills, organisational know-how (e.g. managerial quality) and other forms of knowledge-based capital, such as big data.

Improving job quality and reducing labour market segmentation that tend to disproportionately affect disadvantaged groups such as the youth, the low-skilled and migrants can boost growth by spurring workers’ reallocation and productivity and enhance inclusiveness in the labour market. Improving job quality and reducing labour market segmentation requires reforms in employment protection system, in activation policies, in skills and training programmes among others. Those reforms should protect workers from unfair treatment, while promoting the creation of stable and productive jobs, enhance the quick reintegration of displaced workers and resilience to structural changes such as the digitalisation of economies. Some of these actions need to be specifically tailored on fragile categories of workers, such as the youth, the elderly and the migrants.

Better coordination of product and labour market reforms across different areas would ease implementation, maximise their impact in terms of growth, job-creation and equity at the same time. Governments may consider policy packages designed to minimise the costs of worker displacement as a result of technological change, reforms aimed at reviving business dynamism, and globalisation by enhancing the re-employment prospects of displaced workers. Priority should be given to policies that offer a “springboard” to new jobs, and in particular active labour market policies and reskilling programmes based on the combination of unemployment benefits with effective monitoring and enforced sanction systems within a “mutual obligation” framework.
Finally, gender gaps need to be further reduced. To this aim, key priorities include closing the salary gap between men and women by promoting greater pay transparency in firms, taking measures to enhance women’s careers advancement to senior posts, and encouraging women to enter high-growth sectors with better prospects for earnings. Finally, parental leave schemes should be designed to encourage behavioural change by parents around childbirth.

The need for a country-specific policy agenda to make inclusive growth happen in G7 countries

A reflection on how to boost inclusive growth in the context of the G7 is an important step to address the causes of low productivity growth and high or rising inequality. A number of the potential factors behind rising inequality – including technological change, the impact of globalisation and the financialisation of the economy, and the rising dispersion in firm productivity, wage levels and capital income — are cross-border in nature and affect most advanced economies. Moreover, many of the necessary policy responses, such as the ongoing efforts to reduce tax avoidance and tax evasion are, by definition, multilateral. In this context, a discussion on these issues at the G7 can lay the ground for further international co-operation in the future and sends a strong political message about the commitment of G7 countries to boost growth and inclusiveness and enhance public trust.

Country-tailored policy packages can exploit synergies between growth and inclusiveness or mitigate the potentially adverse effects of pro-growth policies on equity. The sources of inequalities in opportunities and outcomes vary from country to country. As a result, there is no single best model or policy mix for achieving inclusive growth that works for all G7 countries. This report provides a general framework through a broad “menu” of policy responses which are known to exploit synergies between growth and inclusiveness or mitigate the potentially adverse effects of pro-growth policies on equity. The potential policy responses laid down in this report are thus not a prescriptive list applicable to all G7 economies. Instead, they provide a “menu” from which individual G7 countries may want to pick and choose to configure a strategy best adapted to their needs and broader policy objectives.
1 INEQUALITIES IN THE OECD: TRENDS, DRIVERS AND COSTS

In light of high income, wealth and well-being inequalities among G7 countries, the OECD launched its Inclusive Growth initiative. These gaps are widening, particularly due to richer households pulling away from their middle and lower income counterparts. Meanwhile, the quality of life of the poorest households has declined or stagnated across G7 economies since the crisis. Noteworthy is the interconnectedness between wealth inequality and well-being, while multidimensional inequalities often tend to accumulate, making it harder for social mobility to take place. Inequalities have also a spatial dimension in many G7 economies. The welfare state plays an important role in redistributing market incomes, but many tax and benefit systems have become less redistributive in recent years. Beyond transfers, publicly provided social services play an important redistributive role in the G7. The consequences of inequalities are large, including piling quite an amount of pressure on public social budgets. The OECD’s work on the Productivity-Inclusiveness Nexus has outlined a number of potential common drivers for the dispersion in both productivity and wages, which are important drivers behind inequality. This chapter discusses the factors driving inequality, and aims to shed light on government reforms that can benefit a more all-encompassing society, reaping the benefits of economic growth and an interconnected world.

1.1. Trends in inequalities of income, wealth and living standards

Inequalities of income, wealth and well-being have risen or remained stubbornly high in the G7. Over the past two decades, income inequality has widened in a majority of G7 countries, often with large regional discrepancies, as richer households have pulled away from their middle and lower income peers. A similar picture emerges in the evolution of living standards: the welfare of those at the bottom has stagnated in several countries, with those in the middle faring little better, whilst the top have seen significant improvements. At the same time, wealth is even more unequally distributed in all countries, cementing the unequal outcomes of one generation to weigh down on the opportunities of the next.

In response to rising inequalities the OECD has launched in 2012 its Inclusive Growth initiative. The OECD developed a new vision of economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society. The OECD Inclusive Growth has developed a measurement and a policy framework that assesses the most important policy determinants of growth and inclusiveness and helps governments to identify actionable strategies to respond to the challenge of raising living standard in a fair and sustainable way (Box 1).

<table>
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<th>Box 1. The OECD Inclusive Growth Initiative</th>
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<td>Inclusive Growth is increasingly coming to dominate national economic agendas, as governments are hard pressed to kick-start economic growth and deal with the social fall-out of persistent inequalities. The OECD launched work on <strong>Inclusive Growth</strong> in 2012 against the backdrop of rising inequalities, persistent high unemployment, and falling living standards worldwide; trends which had been exacerbated as a result of the financial crisis. It was born from the dual recognition that inequalities extend beyond income to affect many areas of people’s lives essential for their well-being, and that the persistently high levels of inequality present in many countries have taken a substantial toll on the social fabric of communities, place a profound economic cost on future growth, and reduce trust in government</td>
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and institutions.

The first phase (2012-2014) of the Inclusive Growth Initiative built on the Organisation’s ongoing work on growth, inequalities, well-being, structural reforms and development to identify and better understand policies that simultaneously deliver improvements in living standards and in outcomes that matter for people’s quality of life (e.g. good health, jobs and skills, clean environment, efficient institutions). It was set up further to the New Approaches to Economic Challenges (NAEC) objective of developing a strategic policy agenda for Inclusive Growth to foster jobs and growth and address inequalities, to promote political and economic stability, strengthen social contracts, and improve welfare.

The first phase of the Inclusive Growth Initiative developed a multidimensional approach to Inclusive Growth providing a Framework to assess, promote and monitor inclusive growth. The first phase also delivered a flagship publication: All on Board: Making Inclusive Growth Happen, which offers a description of trends in income and non-income outcomes and introduces the Framework. It discusses win-win policies to deliver stronger growth and greater inclusiveness in areas such as macroeconomic policies, labour market policies, education and skills, competition and product market regulation, innovation and entrepreneurship, financial markets, infrastructure and public services, and development and urban policies. It also includes a discussion on inclusive institutions and the underlying governance requirements for the design and implementation of Inclusive Growth policies. Further to this, an outreach campaign supported the development and dissemination of the Framework through consultations with external stakeholders. Several workshops and conferences were convened at the country level, with the release of the first Inclusive Growth National Case Study, All on Board: Making Inclusive Growth Happen in China.

The Inclusive Growth programme of work for 2015-16 was built on the findings from the first phase and focused on four main pillars (methodological, sectoral, national and regional). The work was carried out in conjunction with experts across the OECD and with guidance and oversight by the substantive directorates/committees working on economic, labour, social and statistical issues. The end of the biennium resulted in the release of The Productivity-Inclusiveness Nexus; A new approach to boost productivity growth while, at the same time, reducing inequalities of income and opportunities. The report begins by examining the trend slowdown of productivity growth, which has been observed in many OECD countries over recent years, and the longer-standing rise - and persistence - of inequalities of income, wealth, well-being and opportunities. It then gathers the most recent empirical evidence on some of the common foundations behind these trends and considers possible linkages.

Additionally 2016 launched the Champion Mayors for Inclusive Growth; the creation of a coalition of Champion Mayors, who have committed through various platforms (New York Proposal for Inclusive Growth in Cities and the Paris Action Plan for Inclusive Growth in Cities) to tackle inequalities and promote a more inclusive economic growth in cities. Further to this through the Group of Friends for Inclusive Growth; (an advisory board of Ambassadors, chaired previously by Ambassador Johannes, USA and currently Ambassador Serrano, Chile) 2016, also saw the first Dialogue on Inclusive Business, an occasion for business leaders to share experiences and best practices. With the ultimate goal of the business sector, countries and local governments forging a partnership to identify concreate ways to create inclusive economic growth.
1.1.1. Income inequality remains high in most OECD countries

Over the past two decades, income inequality has widened in the G7. In 2014, average disposable income inequality in the G7, as measured by the Gini co-efficient (0 very equal to 1 very unequal), had risen to 0.33, up from 0.31 in 1995. Nationally, disposable income inequality stood at a higher level than it in the mid-1990s in five G7 countries (France, Japan, Germany, Canada, and the United States), with the rise particularly marked in Germany, Canada, and the United States. In 2014, levels of disposable income inequality in the remaining two G7 countries (Italy and the United Kingdom), had returned to their mid-90s starting points, despite considerable variance over the period in question (Figure 1). In all cases, inequality in 2014 remained high by recent historical standards.

Figure 1. Income inequality has widened in a majority of G7 countries

Gini coefficient of disposable income inequality (mid 1990s to 2014 or latest)

Note: Data for USA (2015) and France (2014) are provisional.

However, growth in income inequality has not been uniform over time. Indeed, growth in disposable income inequality in the G7 has tended to occur in sporadic spurts, at different times across different countries since the mid-1990s. For instance, much of the rise in inequality in Germany occurred in the first half of the 2000s, whilst in Canada the defining period was the second half of the 1990s. The impact of the global financial and economic crisis of 2008-09 has not been evenly felt either, with inequality increasing in the wake of the recession in the United States and decreasing in the United Kingdom, whilst remaining broadly stable in the other G7 countries. This serves to underline how the complex mix of factors at play (including domestic policies, global developments and technological change) have interacted in different ways to drive growth in inequalities in country specific contexts over time.
Rising inequality in G7 countries has, in large part, been down to richer households pulling away from their middle and lower income peers, a trend often exacerbated by the crisis and during the economic recovery. Over the past two decades, disposable incomes at the top have risen faster than those for the bottom 10% and even the bottom 40%. Although, on average, real incomes have recovered the drop seen during the recession, the uneven recovery in the wake of the crisis of 2008 has, in several instances, exacerbated this trend. In the immediate aftermath of the crisis as automatic fiscal stabilisers kicked-in and top incomes took a hit (particularly in the financial sector) inequality initially declined in some countries, but subsequent faster growth of top incomes and weaker improvement at the bottom have meant that overall income inequality did not recede in the majority of countries during the recovery (Figure 2). In addition, inequality in market incomes has risen significantly over the past three decades with the share of top-income recipients in total pre-tax income increasing in most countries, as the top 1% captured a very large fraction of total growth in pre-tax incomes in the United States (47%), in Canada (37%) and in the United Kingdom (around 20%).

**Figure 2. In some countries, household disposable incomes are still below pre-crisis levels**

Real disposable income growth between 2007 and 2014 (or latest year) by income group, total population, OECD average

![Graph showing disposable income growth between 2007 and 2014 for different countries.](image)

Note: Data for the United States refer to 2008-2015; Data for France refer to 2008-2014; 2006-2012 for Japan; and to 2007-2013 for the other countries. Data for USA (2015) and France (2014) are provisional.

Source: OECD Income Distribution Database (IDD), www.oecd.org/social/income-distribution-database.htm, as at 17/01/17

1.1.2 Inequalities in G7 countries extend far beyond income to touch many vital areas of life

Taking a broader view of welfare outcomes highlights how the quality of life of the poorest households has declined or stagnated in most G7 economies since the mid-1990s. The OECD has developed a broader measure of multidimensional living standards that considers job and health outcomes, as well their distribution, together with income inequality. This more comprehensive measure of economic welfare shows that, since 2008, the living standards of the poorest have stagnated in three of G7 countries and strongly declined in Italy (Figure 3, panel a). However, in all G7 economies, the main detractor to growth in living standards has been higher income inequality (Figure 3, panel b). Beyond the poorest households, the median G7 households have experienced a similar evolution, though the
slowdown of living standards growth in the wake of the great recession has been less dramatic than for the poorest.

**Figure 3. The quality of life of median and bottom 10% households has declined or stagnated in most G7 economies since the crisis**

Panel A. Multidimensional Living Standards of Median Households, US dollars PPP

Panel B. Multidimensional Living Standards of bottom 10% households, US dollars PPP

Source: OECD Calculations based on Boarini et al., 2016

1.1.3. Wealth in the G7 is much more unequally distributed than income

Across the G7, wealth is much more highly concentrated than income. By dint of the fact that it is accumulated over time, wealth is distributed much more unequally than income. On average across the OECD countries, the 10% of wealthiest households possess half of total wealth, the next 50% hold almost the other half, while the bottom 40% own little over 3% (Figure 4). Across the G7, wealth is most concentrated in Germany and the US. In recent decades, tax data indicate that wealth inequality has grown, often linked to increases in stock and housing prices relative to consumer prices (OECDa 2015).

**Figure 4. Wealth is highly concentrated in the hands of the top 10%**

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

Source: OECD (2015a), Secretariat calculations from OECD Wealth Distribution Database
Moreover, high wealth inequality likely has important implications for well-being and equality of opportunities. An unequal distribution of household wealth fuels inequalities, as accumulated wealth can generate capital income, which, in turn, can deepen income inequality. This has been exacerbated by Financialisation (i.e. the increasing weight of financial activities and institutions in our economies), as people with higher incomes have benefited more than their poorer peers from credit-financed investment opportunities (Denk and Cazeneuve-Lacroutz, 2015) whilst lower-income groups have fewer opportunities to invest in housing and other assets. In this respect, wealth inequalities shape people's individual circumstances and future opportunities, but also determine their capacities to grasp said opportunities.

1.1.4 The unequal outcomes of one generation tend to frame the opportunities of the next

Multidimensional inequalities often tend to accumulate, making it harder for disadvantaged children to climb the socio-economic ladder. Inequalities of wealth, income and well-being outcomes stand in a symbiotic relationship with inequalities of social capital, such as cultural exposure and access to parental networks. Together, they influence formative outcomes in children’s lives, such as the quantity and quality of education children can expect and their future labour market engagement. In turn, these unequal learning and labour market outcomes contribute to growing income and wealth inequalities, perpetuating a vicious cycle. This complex mechanism is illustrated through the impact that one generation’s earnings have on the pay of their immediate descendants. Earnings’ persistence from one generation to the next is strong in a number of G7 countries, including France and Italy, but considerably lower in Canada and Japan (Figure 5). This latter point serves to highlight that the link between income inequality and intergenerational social mobility is complex. Although the level of income inequality is either similar or higher in Canada and Japan than in France and Italy, factors other than parents’ socio-economic status can influence children’s labour market outcomes, suggesting that public policies have an important role to play in ensuring that children from disadvantaged backgrounds have similar opportunities to climb up the socio-economic ladder.

Figure 5. Outcomes for one generation frame the potential of the next

Persistence of earnings from fathers to sons

Note: The height of each bar represents the best point estimate of the inter-generational earnings elasticity. The higher the parameter, the higher is the persistence of earnings across generations, and thus the lower is inter-generational mobility. Estimates refer to sons and fathers of prime-age.

Income inequality has a strong influence on education outcomes, wasting potential and hindering social mobility. Across the G7, parental educational background influences children’s opportunities to pursue an education. On average, in the G7, children with lower-educated parents have just a 15% chance of attaining tertiary education. Whereas, they would have been four times more likely (63%) to finish university if at least one of their parents had attained tertiary education (Figure 6). At the same time, children with better-educated parents are six times less likely to drop out at lower secondary level or before, compared to students whose parents have a lower educational background. There are, however, wide differences across countries. In Italy, a person whose parents did not attain upper secondary education is ten times more likely to not attain upper secondary level herself than to reach tertiary education. In Canada, the same individual will actually be more likely to attain tertiary education than stay at the same level as their parents.

Figure 6. Income inequality has a strong influence on education outcomes, wasting potential and hindering social mobility

Panel A. Likelihood of educational attainment, by parents’ educational attainment

Panel B. Likelihood of educational attainment, by parents’ educational attainment


However, the structure and focus of G7 educational systems plays an important part in determining the extent to which inequalities influence opportunities. The latest OECD PISA results show that in the G7, Japan and Canada have the highest proportions of students from the most disadvantaged backgrounds performing in the top quarter (so called “resilient” students), while France and Italy have the lowest, mirroring the elasticity of intergenerational earnings (Figure 5). The PISA results also show that between 2006 and 2015, some G7 countries made large gains in educational equity. For instance, Germany, Japan, the United Kingdom and the United States all saw significant improvements, with the latter seeing the average impact of socio-economic status on science performance decrease by 13 score points. These countries also saw the percentage of resilient students grow, with the United States registering the largest improvement at 12.3 points, and Germany, Japan and the United Kingdom all seeing gains of between 5 and 9 points.

1.1.5. Inequalities in the G7 have a profoundly spatial dimension

Many G7 countries see large regional income divides, with big differences within countries: between urban and rural areas and between cities. People living in cities earn on average 18% more than those living elsewhere, though differences in living costs might partially offset earning differences. At the same time, income inequality is also higher, on average, in cities than elsewhere and tends to be higher in the largest cities. The concentration of highly skilled workers and the most productive firms in large cities
as well as the existence of agglomeration economies contribute to explain these inequalities. In addition, there are large differences among cities in the same country (Figure 7).

**Figure 7. Many G7 countries see large divides between cities and regions**

Average household disposable income in metropolitan areas

![Graph showing average household disposable income in metropolitan areas](image)

**Note:** The figure plots metropolitan areas, defined by the OECD as agglomerations with at least 500,000 inhabitants. For more information on the definition of metropolitan areas, see OECD (2012), *Redefining “Urban”: A New Way to Measure Metropolitan Areas*, OECD Publishing, Paris. DOI: [http://dx.doi.org/10.1787/9789264174108-en](http://dx.doi.org/10.1787/9789264174108-en)


Moreover, such spatial disparities tend to be larger when multidimensional living standards are considered. Regional disparities are higher in almost all OECD countries when considering multidimensional economic welfare, than when considering household income only. Disparities exist not only in the levels of economic welfare, but also in how welfare has evolved over time. In the best performing Canadian and French regions, for instance, the growth of multidimensional living standards can be mainly accounted for by an increase of household income. In the case of Italy and the United Kingdom, the largest contributor to the rise of multidimensional living standards was an improvement in health outcomes. Differences in sub-national investment choices play a critical role in the spatial disparities of well-being outcomes. In 6 out of the G7 countries (the exception being the United Kingdom at 35%), subnational governments are responsible for over 50% of public investment and up to 95% in Canada. Subnational governments are therefore critical partners in addressing these gaps.

**1.2 What has been driving the growth of inequalities?**

A wide range of factors have contributed to rising and/or persistently high inequalities. Fiscal redistribution through taxes and transfers plays a crucial role in containing the impact of market income inequality onto disposable income, but this role is changing. More broadly, a number of longstanding
transformational changes to the way G7 economies function have likely impacted inequalities, such trends include: technological change, economic globalisation, financialisation, structural changes in the labour market and changes in family patterns. At the same time, there have also been changes in domestic policy settings which have had a significant impact on the rise in market income inequality, pertaining to regulatory reforms in product and labour markets. The following section examines each of these drivers in greater depth.

1.2.1. The role of fiscal redistribution is vital for reducing market income inequality in the G7

The welfare state plays an important role in redistributing market incomes reducing the gap between richer and poorer households in terms of net disposable incomes. Redistribution in terms of cash transfers, personal income tax and social security contributions is sizeable and, as measured by the percentage reduction in Gini coefficient, amounts to one fourth (24%) among the working-age population, on average across G7 countries (Figure 8). The extent of redistribution varies highly across countries: it is about twice as high in France (34%) and Germany (29%) than in Japan (15%), with the average across OECD countries at 27% (OECD 2016a).

![Figure 8. The welfare state plays a crucial role in redistributing market incomes in the G7](image)

Redistributive effect of taxes and transfer, 2013/14 (or latest year available) Relative reduction in market income inequality (Gini coefficient) due to taxes and transfers (working-age population)


Many tax and benefit systems became less redistributive between the mid-1990s and mid-2000s (OECD 2015a, OECD 2017a and Causa, Hermansen, 2017 forthcoming). The main reasons for this decline can be found on the benefits side: cuts to benefit levels, tightening of eligibility rules to contain expenditures for social protection and the failure of transfers to the lowest income groups to keep pace with earnings growth. The most important benefit-related determining factor in overall redistribution, however, has likely been the decline in the number of people entitled to transfers, as a result of tighter unemployment benefit eligibility rules and broader changes to the labour market including the rising share of non-standard labour contracts.

During the early phases of the global financial crisis, redistribution helped cushion increases in market income inequality, but its role has since tended to fall in a majority of G7 countries in the most recent years (Figure 9). In Europe, this has been largely due to the softening of automatic stabilisers as the economy has recovered. In other countries, it reflects the phasing out of fiscal stimulus, as in the United States, where the extension of unemployment benefit duration carried out in 2008-09 was rolled back in
Weaker redistribution may also result from fiscal consolidation measures pursued in response to rising fiscal deficits.

**Figure 9.** Post-crisis, redistribution helped cushion increases in market income inequality

![Figure 9](https://www.oecd.org/social/income-distribution-database.htm)

Trends in redistribution, 1995-2013/14 (or latest year available); Percentage reduction in market income inequality (Gini coefficient) due to taxes and transfers across G7 countries (working-age population)

Beyond transfers, it is important to recall that publicly provided social services also play an important redistributive role in the G7. Such services account for almost 15% of GDP across G7 countries, slightly more than the spending on cash transfers (14%). Broadening the income concept to account for such in-kind benefits considerably increases household economic resources and impacts on inequality and poverty outcomes (OECD 2011a). Household income is, on average, 30% larger after imputing social public services. Relatedly, depending on the inequality indicator giving more weight to the bottom than to the top of the income distribution, income inequality would fall between one-fifth and one-third when public services are accounted for.

### 1.2.2. Globalisation has increased the difficulty for governments in taxing mobile capital income

Increased levels of capital mobility worldwide have been accompanied by the increased use of tax havens as a means to shelter income and assets offshore. Estimates of the size of offshore assets range from USD 6.1 to 7.6 trillion (Pellegrini et al., 2016; Zucman, 2014). This has increased tax distortions and reduced the overall progressivity of the tax system, however, it was not the main driver of reduced progressivity. At the same time, tax competition has not been confined to capital income. There is some evidence that jurisdictions are not only engaged in tax competition with respect to the corporate income tax system, but also with respect to the personal income tax system, creating tax incentives to attract the tax residency of high-net-worth individuals for tax purposes, with a view to taxing their personal income tax at low rates (Kleven, Landais, Saez, & Schultz, 2013; Kleven, Landais, & Saez, 2013). This also drives down top tax rates. At the same time, it is important to remember that tax competition can be useful in redistributing the geographical location of economic activity, to the benefit of some countries and regions over others.

These factors have meant that governments have increasingly sought to use taxes on less mobile bases to finance government expenditure. For instance, social security contributions and payroll taxes have increased 4 percentage points as a share of GDP in the G7 since 1970, accounting for 57% of the increase in the tax to GDP ratio over that period. Hence, expansions in the amount of tax revenue of a typical G7 country have been financed predominantly through taxes on labour.
1.2.3. Technological change and globalisation may have led to higher market income inequality

Most of the rise in market income inequality has been driven by earnings inequality, which has itself largely been caused by increased wage differentials across firms, with skill-biased technological change as a key driver. In G7 countries, such as Germany, Italy, the UK and the US, earnings inequality and wage differentials across firms are strongly correlated. This trend has also been seen across a broader set of OECD economies (Figure 10) (Berlingieri, Blanchenay and Criscuolo, 2017).

Figure 10. In several G7 countries earnings inequality and wage differentials across firms are strongly correlated

The “Great Divergence” - wage dispersion over time within sectors and OECD-14 countries

Note: The figure plots the estimated year dummies of a regression of log-wage 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

Evidence suggests that rising wage dispersion in the G7 may be associated with increased productivity dispersion (Berlingieri, Blanchenay and Criscuolo, 2017). Figure 11 shows that in non-G7 OECD countries, the increase in dispersion is concentrated at the bottom of the distribution for both wages and productivity; while in G7 economies the increase in dispersion is a more general feature of the entire distribution.
Figure 11. Wage dispersion in the G7 may be associated with increased productivity dispersion between firms

Panel A. Wage and labour productivity dispersion at the top versus bottom of the distribution, non-G7

Panel B. Wage and labour productivity dispersion at the top versus bottom of the distribution, G7

Note: covering manufacturing and non-financial market services sectors. G7* include FRA, ITA and JPN; Non-G7 countries include AUS, AUT, BEL, CHL, DNK, FIN, HUN, NLD, NOR, NZL, SWE. The graphs can be interpreted as the cumulated growth rates of dispersion at the top and the bottom of the distribution within each country and sector over the period. The estimates reported in the graph are those of Year dummies in a cross-country regression of log-productivity (log-wage) dispersion, both at the top [90th to 50th percentiles ratio of log-productivity (log-wage)] and the bottom [50th to 10th percentiles ratio of log-productivity (log-wage)] of the distribution, with country-sector fixed effects.

Source: MultiProd dataset (see: https://www.oecd.org/sti/ind/multiprod.htm)

The OECD’s work on the Productivity-Inclusiveness Nexus has outlined a number of potential common drivers for the dispersion in both productivity and wages. Indeed, work on the Nexus has suggested several mechanisms including skill-biased technological change which, through the rise of ICT, increases the productivity and the demand of high-skilled workers and jobs with non-routine tasks, thus raising their relative wages vis-à-vis low-skilled workers and jobs with routine tasks (several other authors have also noted this including: Card and Di Nardo, 2002; Autor and Acemoglu, 2011). As a result, the earnings gap between high and low-skilled workers has been growing.

The Nexus also highlights that frontier firms are better-placed to lock-in superior productivity performance. 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 (GVCs) 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. In sectors with high concentrations of Knowledge Based Capital (KBC) and strong uptake in Information Communication Technologies (ICTs), characterised by network externalities, frontier firms may even be benefitting from increased market concentration through the accrual of rents. Lagging firms, which are smaller, less productive, less globally engaged, and that pay lower wages, are held back by a variety of domestic policy impediments, ranging from housing policy that undercuts labour mobility, to poorly functioning financial institutions that evergreen lending, to regulated services that raise the costs of doing business.
Evidence on the impacts of globalisation on wage inequality is less clear cut, although globalisation and technological change are inherently linked and their effects are difficult to disentangle. With this caveat in mind, evidence does tend to suggest that increased imports from emerging economies – in particular from developing and emerging economies – tends to heighten wage dispersion in OECD countries with weaker employment protection legislation, albeit the effects on overall employment levels with labour mobility is less obvious. The increase in import penetration and offshoring has put workers in direct competition with low-skilled low-paid workers from emerging economies (e.g. China as of the late 1990s), reducing their wages and increasing wage inequality (Autor, Dorn, Hanson, 2013). Recent OECD work (Berlingieri, Blanchenay and Criscuolo, 2017) finds that globalisation and digitalisation are not only associated with an increase in between-firm wage inequality, but also strengthen the link between wages and productivity dispersion. Absent changes in policy settings, rising globalisation and digitalisation suggest that future increases in productivity dispersion may also increase wage inequality.

The structural shift towards more temporary, part-time work and self-employment has likely also contributed to market income inequality growth. Such employment accounts for about a third of total employment in the OECD and nearly half of all jobs created since the mid-1990s. All G7 countries have seen ‘job polarisation’ with the hollowing out of the middle of the job and wage distribution, as a growing share of the workforce is working either in high-skill, high-wage jobs characterised by abstract tasks, or in low-skill, low-paid jobs while the employment share of medium routine jobs has been decreasing (Figure 12).

Evidence suggests that more coordinated wage setting tends to reduce wage dispersion, particularly in sectors with higher productivity dispersion. However, the effect is more limited if these sectors are also more exposed to import competition, which might lead to additional pressure on social protection policies. One potential explanation is that increased import competition might give firms more bargaining power as it provides them with a credible threat (e.g. of offshoring).

1.2.4. Financialisation has had several important impacts on market income inequality

Financialisation has exacerbated income inequality in OECD countries. Over the past fifty years, credit from banks and other intermediaries to households and businesses has grown three times as fast as economic activity. Empirical evidence suggests that more finance, in the form of more bank credit or
larger stock markets, goes hand in hand with higher income inequality across OECD economies (Box 2) (Denk and Cournède, 2015). Further expansion in bank credit from the levels observed in OECD countries is associated with slower household income growth, but the negative effects are particularly acute at the bottom of the distribution, while simulations suggest that the top 10% benefit. Stock market expansion is linked with stronger household income growth, but the benefits are concentrated at the top, whilst the very bottom of the income distribution is simulated to lose out. These effects, which have been identified on average across OECD countries, might not apply at lower levels of development (Cournède et al., 2015).

By growing much faster than GDP, private credit accounted for a quarter of the increase in income inequality. Estimates suggest the strong expansion of private credit over 1990-2010 contributed 0.8 Gini points to the 3.1 Gini-point widening of household disposable income inequality observed during the period (in the OECD countries for which the data are available). What is more, many large banks tend to benefit from an implicit government guarantee which lets them assume more risk, extend more credit and pay higher salaries (remunerations), exacerbating the problems of financial growth and inequality as outlined (Denk et al., 2015).

### Box 2. The Impact of Financialisation

OECD work highlights three key mechanisms (while not excluding other ones) behind this link:

**Financial sector workers are very concentrated at the top of the income distribution.** In Europe, financial sector employees make up only 4% of the workforce but 20% of the top 1% earners. In Luxembourg and the United Kingdom, more than 30% of employees in the top 1% work for financial firms. This is justified as long as very high productivity underpins their earnings. However, detailed econometric investigations find that financial firms pay wages well above what employees with similar profiles earn in other sectors. Even worse, the premium is especially large for top earners.

**High earners can and do borrow more.** The distribution of credit is twice as unequal as income in euro area countries (where internationally comparable data are available). More than 45% of total household credit goes to the top 20% of the income distribution in Austria, Finland, France, Germany and Italy. Credit expansion also fuels income inequality, as the well-off gain more from investment opportunities.

**Much of the benefits of stock market expansion goes to affluent households.** Stock holdings are disproportionately concentrated in the hands of high-income people. In the euro area, stock market wealth is four times more unequally distributed than household income. As a consequence, larger stock markets, which generate more dividends and capital gains, widen the income distribution.

*Source: Denk and Cazeneuve-Lacroutz, 2015*

### 1.3 The Consequences of Growing and Persistently High Inequalities

There are numerous socio-economic costs to rising inequalities, with important implications for government budgets. This section explores the potential costs of high and rising inequalities in terms of their impact on productivity, economic growth and ultimately government budgets. Beyond their effect on social cohesion, inequalities constrain the ability of low-income groups and disadvantaged regions to contribute to economic growth. Moreover, the different drivers of inequality tend to interact with one another reinforcing their overall impact. Indeed, issues like the marked intergenerational transmission of low human capital accumulation, high skills mismatch, and inefficient healthcare management tend to
interact to create more unequal, less robust growth and ultimately add to, or in the very least do little to alleviate, the pressures on government coffers.

1.3.1. Income inequality may impact productivity and economic growth

Widespread increases in income inequality are a source of concern not only for their effect on social cohesion, but also for their potential impact on economic performance. Economic theory predicts both positive and negative impacts from inequality on growth and the question of which effect dominates hinges on the specific context. Recent work drawing from the experience of OECD countries over the last three decades, shows that when income inequality rises, economic growth slows down (OECD, 2015a). The negative association of inequality with growth is driven by the income gaps between lower income households and the rest of the population. This is true not just for the lowest earners – the bottom 10% less affluent households – but for a much broader swathe of low earners – the bottom 40%. However, the assumption of a monotonic and linear relationship between income inequality and economic growth can be questioned. Economic theory provides arguments for which the shape of relationship may be positive for low levels of inequality and negative for high ones. Recent cross-country analysis by the IMF based on a large panel of advanced and emerging economies finds evidence of nonlinearities, though it suggests that from all G7 economies lower inequality would have a positive impact on economic growth (Grigoli and Robles, 2017).

Higher inequality constrains the ability of low-income groups to contribute to economic growth, hindering their accumulation of human capital. Families in low-income groups may be unable to keep their children in education for as long as is optimal, or to afford high-quality education, thereby harming their future earnings, they may also find it difficult to borrow to invest in new opportunities. As a result, economic growth is slower than it could otherwise be and disproportionately benefits the better-off. In turn, under-investment by the low income groups results in low social mobility, talent misallocation, hence lower efficiency and aggregate output. For instance, an increase in inequality of around 6 Gini points (corresponding to the income inequality differential between the United States and Japan) is associated with a lower probability of around 4 percentage points for individuals with low parental educational background (PEB) graduating from tertiary education, whilst the effect is negligible for those with medium and high PEB. The impact of higher income inequality on children from poorly educated families can also be seen in skills proficiency, with numeracy scores, declining markedly for children from poorer low PEB backgrounds when inequality rises (Figure 13).

Figure 13. Higher inequality constrains the ability of low-income groups to contribute to economic growth, hindering their accumulation of human capital

Average numeracy score by parent educational background (PEB) and inequality

Note: Average predicted numeracy score for individuals three parental (educational) backgrounds, as a function of the degree of inequality (Gini points) in the country at the time they were around 14 years old. Low PEB: neither parent has attained upper
Beyond human capital accumulation, failure to promote effective skills use has contributed to slow productivity growth and enhance inequalities. Because productivity growth depends on human capital, an environment in which some people have few resources and find it difficult to get and keep a good job, to save and invest in their own skills, and to support good quality education for their children, tends to hinder aggregate productivity growth. Countries that make better use of their workforce’s skills tend to exhibit lower wage inequality and higher productivity growth. As a result, skills mismatch in OECD countries represents a drag on productivity as well as potentially a factor contributing to wage inequality. Simulated gains to moving all countries to the highest level of skill matching observed in the OECD would result in considerable gains in aggregate productivity, for example, a 3% gain in the United States and a 10% gain in Italy (McGowan and Andrews, 2015).

The wage distribution and its link with productivity dispersion are significantly impacted by countries’ wage setting mechanisms and labour market policies. Recent OECD analysis (Berlingieri et al., 2017) shows that the role of wage setting mechanisms and labour market policies, including i) minimum wages; ii) trade union density; and iii) coordination in wage setting, can act to reduce wage dispersion and hence overall inequality, whilst significantly affecting the link between wage and productivity dispersion. For instance, higher employment protection legislation and more centralized bargaining are associated with a weaker link between productivity and wage dispersion. Labour markets characterised by significant dualism between workers on permanent, more stable jobs and those in atypical and often precarious ones tend to be also less inclusive and with a more unequal wage distribution and lower productivity growth. Those that suffer most from such a ‘dual’ labour market are the youth and the low skilled, in particular, who get trapped in temporary and precarious employment. This high but concentrated-at-the-margin churning is not conducive to the reallocation of labour to more productive uses and, at the same time, contributes to inequality in the labour market and skill mismatch.

Multidimensional inequalities also impact productivity and growth, with the effect of health inequalities being particularly damaging. Across the EU, 78% of people in the highest income quintile report being in good health, compared with only 61% for people in the lowest income quintile. There are also large disparities by socioeconomic status for diseases and risk factors that are major causes of disability and lower quality of life. In particular, people with the lowest level of education are more than twice as likely to report having chronic obstructive pulmonary disease (COPD) and diabetes as are those with the highest level of education. The economic impact of such health inequalities is significant. People in ill-health are more likely to be unemployed, are less productive when they do work and earn less.

1.3.2. There is a regional dimension to the relationship between inequality and growth

On average, more unequal regions have experienced slower growth rates of GDP per capita. The growth-inequality nexus has a geographical dimension, depending on whether we look at global, national, or regional levels. Recent OECD evidence provides granular evidence on the association between regional inequality and regional economic growth (Figure 14) (Royuela et al., 2014). Based on a sample of 15 countries over the period 2002-12, there is a negative correlation between income inequality within a region and the region’s growth. Indeed, more unequal regions have experienced subsequent slower growth rates of GDP per capita, on average. The correlation is found to be stronger after 2008, suggesting that more equal regions also showed stronger resilience against the economic crisis. The negative inequality-growth relationship is also found to be sensitive to the size of cities. Less inequality is
associated with higher growth especially in large cities, where inequality is already higher than the
average.

**Figure 14.** On average, more unequal regions have experienced slower growth rates of GDP per capita

Income inequality and growth of GDP per capita, OECD regions

![Graph showing income inequality and growth of GDP per capita, OECD regions]


### 1.3.3. Rising inequalities pile further pressure on public social budgets

**The pressure on public social budgets has increased over the past 25 years.** Since 1990, public social spending on average across the OECD increased from 17.1% in 1990 to 21.2% in 2014 (*Figure 15*). The increase is not on income support for the working-age population, but rather on health and old-age and survivor pensions. With population ageing, health and pension spending can be expected to increase further, as on long-term care (as grouped under other social services).

**Increases in market income inequalities may put further pressure on fiscal budgets.** Larger inequality may bear a greater fiscal cost, even though properly measuring such cost is analytically difficult, not least because the link between tax and transfer policies and inequality outcomes likely goes in both directions and varies according to the time horizon. Still, there are several channels through which larger inequality may pressure fiscal space. Direct channels include increasing need for transfer redistribution, whether first-tier employment-related cash transfers or minimum-income social safety nets; as well as foregone tax revenues. Indirect channels include potential negative effects on output growth, for instance because of low accumulation of human capital by disadvantaged groups, which in turn implies lower productivity, further reducing fiscal budgets. To the extent that skill-biased technological change is likely to continue translating into rising earnings dispersion, the challenge at stake for fiscal policy is likely to increase in the future, which calls for a careful reassessment of the current design of taxes and transfers in the light of fiscal, growth and inclusiveness objectives.
Figure 15. The pressure on public social budgets has increased over the past 25 years

Public social spending by broad policy area, OECD unweighted average, 1990, 2000 and 2014 or latest year available, in per cent of GDP

1. Income support to the working-age population refers to spending on the following SOCX categories: Incapacity benefits, Family cash benefits, Unemployment, active labour market programmes and other social policy areas.

Taxes and transfers can play a critical role in fostering inclusive growth. Many growth-enhancing tax reforms can have adverse effects on the distribution of income and wealth, presenting challenges for policymakers as they pursue inclusive economic growth. An inclusive growth tax agenda should move beyond the traditional policy trade-offs between equity and efficiency. Changes in the international tax environment create new opportunities to reduce inequality without reducing growth. Furthermore, an integrated fiscal policy reform is necessary to achieve inclusive growth. This chapter explores how the trade-off can be reconciled and outlines a number of reforms that can promote both growth and equality at the same time. It concludes by recommending concerted action across three main areas: strengthening the progressivity and the efficiency of the tax system; designing social welfare systems more effectively to build resilience and flexibility across the income distribution; and optimising spatially-targeted fiscal expenditures through exploiting under-employed labour, land and infrastructure in distressed regions and communities.

2.1 The Role of Tax and Transfers and the Impact on Incentives

Fiscal policy can be a powerful instrument for Inclusive Growth if trade-offs are properly managed. Growth-enhancing reforms of tax and transfers can have adverse effects on the distribution of income and wealth, presenting challenges for policymakers as they pursue an Inclusive Growth strategy. An Inclusive Growth fiscal agenda should move beyond the traditional policy trade-offs between equity and efficiency. While these trade-offs do exist, this chapter explores how they can be addressed and outlines a number of fiscal reforms that either promote both growth and equality at the same time or take into account any trade-offs between them.

Integrated fiscal policy reform is necessary to achieve Inclusive Growth. Instead of focusing on a given type of tax or transfer, policy reform should focus instead on the overall impact of the entire fiscal system on both productivity and equity to avoid sub-optimal economic and social outcomes. Moreover, an Inclusive Growth fiscal policy agenda should reduce inequality not just through tax-and-transfer redistribution but by making the pre-tax distribution of income more equal as well, for instance by supporting private investment in human capital and by shaping labour supply and demand.

2.1.1 Strengthening the overall progressivity of the tax system

Strengthening the overall progressivity of the tax system should be a priority for Inclusive Growth, and many are the levers that can be utilised to this effect. Amidst rising inequality in some OECD economies, tax systems could become more progressive, so that those who have benefited most from economic growth play a larger role in financing public goods and public investment. Tax progressivity can carry well-known efficiency costs, reducing investment, entrepreneurship and labour supply, and also providing stronger incentives to avoid and evade tax, especially for high-income taxpayers (Mankiw, 2013; OECD, 2010a). However, some studies have argued that progressive taxation can be also beneficial from an efficiency perspective Saez and Stantcheva 2011, Bivens and Mishel, 2013, Goolsbee, 2000).

Broad measures of progressivity suggest that the effectiveness of income tax in reducing inequality has fallen. The progressivity of statutory tax rates has increased at lower income levels as governments have strengthened incentives for these workers to participate in the labour market (Figure 16, panel A).
However, statutory tax progressivity has fallen at higher income levels (Figure 16, panel B). Recent OECD research has found there has been a slight decline in the size of personal income taxes, which entailed a reduction of the effectiveness of these taxes in reducing inequality over this period (Causa and Hermansen, forthcoming).

Figure 16. Personal income tax progressivity has increased at the lower end of the income distribution, and decreased at higher income levels

Personal income tax progressivity by income level and family type

Capital tax reforms are also necessary, with a focus on those kinds of assets favoured by those on higher incomes. Capital income is taxed progressively, though at lower rates than labour and with a lot of variation in taxation across asset types. Capital tax rates have fallen over recent decades, though they have risen modestly in the post-crisis period (see, for example, OECD, 2016d). Though savings taxation is mostly progressive (except for the taxation of private pensions) it also varies substantially across asset types. Bank deposits are a common form of savings vehicle for those with low incomes and low levels of wealth are comparatively heavily taxed, while private pension savings being often subsidised.

There is scope to increase the taxation of capital income but reforms need to take into account that high-income individuals can move in response to onerous tax burdens. Taxing capital income is important but increasingly challenging in borderless economies. Addressing these challenges requires:

- *Strengthening international cooperation on the taxation of mobile tax bases.* Information exchange agreements and further international cooperation in areas like beneficial ownership and Automatic Exchange of Information - will reduce opportunities for evasion of tax on capital income (Chapter 4). These changes mean it could become possible for policymakers to raise effective tax rates on capital income and increase tax progressivity while reducing economic distortions and income shifting (Brys et al., 2016; Kopczuk, 2005). Reducing tax avoidance and evasion restores trust in the tax system, allows countries to raise tax more fairly and increases tax efficiency. Such efforts need to take into account that high wealth individuals can change their tax residency and even their citizenship in response to high taxes.
• **Removing tax expenditures that disproportionately benefit higher incomes.** Capital tax reform is also necessary domestically to reduce rate differentials across asset types that distort savings decisions and incentivise tax planning. Many different kinds of savings are taxed in different ways, increasing distortions and providing opportunities for tax avoidance. In addition, tax expenditures such as tax deductions for private pension contributions and mortgage interest are regressive and can be inefficient (OECD, forthcoming b). Removing such tax expenditures could simultaneously reduce inequality and make the tax system more efficient (see also Section 2.2).

• **Strengthening progressivity of tax bases other than income, starting from property taxes.** OECD research has highlighted the importance of considering the overall progressivity of the tax and benefit system as opposed to focusing solely on the top marginal rate of personal income tax (Brys et al., 2016). Proportional or even slightly regressive taxes such as the value-added tax (VAT) may increase the overall progressivity of the tax and transfer system if they finance spending targeted at those on lower incomes (Box 3).

<table>
<thead>
<tr>
<th>Box 3. Strengthening the progressivity of property taxes</th>
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<td>Increased taxation of residential property can increase both growth and strengthen progressivity. This is especially true if this taxation is used to finance reductions in more distortive taxes (O’Connor et al., 2015). 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 (OECD, 2010a). The importance of property and land taxes may rise in coming years as immovable property becomes an even more attractive vehicle for holding assets offshore. In these circumstances, new approaches such as the targeting of high-value properties with transaction taxes could be considered even though these taxes might otherwise be considered to be distortive. Strengthening inheritance and gift taxes can support inclusive growth. 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. Inheritance taxes are less distortionary than personal and corporate income taxes and can help achieve intergenerational equity goals and reduce market income inequality. However, tax evasion and avoidance has made these taxes difficult to collect, and their high salience has made them unpopular. In order to be effective, inheritance taxes must also be combined with taxes on gifts and wealth transfers during the taxpayers’ lifetime, as well as with measures to address avoidance and evasion, including enhanced exchange of information between tax administrations.</td>
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2.1.2 Broadening tax bases

Broadening tax bases can increase efficiency and progressivity of tax systems. Base-broadening, rate-reducing reforms can raise growth rates by reducing deadweight losses from taxation and improving incentives across the economy (Brys, et. al., 2016; OECD, 2001, 2010). Broad-based tax systems can also make the tax system more progressive. Many tax expenditures benefit those on higher incomes more than those on low incomes, such as mortgage interest deductibility and deductibility of private pension contributions (Figure 17). Removing or limiting these tax breaks can raise average rates without raising marginal rates (OECD, forthcoming b), making the tax system both fairer and more growth-friendly.
Base broadening can also help raise progressivity with respect to indirect taxes. For example, some countries have sought to use reduced VAT rates to support those on low incomes, but these reduced rates often provide larger benefits to those on higher incomes (OECD, 2014a). Removing tax expenditures that are poorly targeted (e.g. reduced VAT rates on restaurant food and hotel accommodation) while compensating those on low incomes directly through the tax or benefit system can raise tax efficiency while also reducing inequality (Figure 18).

Base broadening should not be confined to the removal of tax expenditures, but should also include the identification of new bases. In many countries, for example, certain forms of income such as capital gains are exempt or heavily shielded from taxation; other bases such as land and immovable property are often taxed lightly. Governments should seek to make the tax base as comprehensive as possible across all forms of income and gains to maximise efficiency and remove arbitrage opportunities. This will require careful integration of the taxation of corporate and capital income and gains and requires innovative tax design to ensure the effective taxation of capital income.
Broadening the base of social security financing is particularly important. Structural changes in the economy - including increasing numbers of self-employed, temporary and other atypical work contracts - present challenges for welfare states financed by social security contributions. These contributions place a heavy burden on labour market activation, present significant financial challenges for governments, and can widen gaps between those in standard jobs and those in non-standard jobs. In spite of this, they have accounted for a large part of the increase in the tax-to-GDP ratio across the OECD over the past 50 years. Financing social insurance from general taxation revenue instead of social security contributions can raise labour market participation, reduce labour market dualism and boost growth, while at the same time extend welfare support to a larger fraction of society. This is particularly the case for benefits that are weakly linked to the level of social security contributions made, such as unemployment benefits and child cash transfers.

Not all base narrowing measures are necessarily harmful to inclusive growth. Tax expenditures such as R&D Tax Credits and Earned Income Tax Credits do narrow the tax base, but also address important externalities in the tax system, and can lift levels of productivity, activation, and wages (Appelt et al., 2016; OECD, 2011b).

Tax policy reform should take into account the entire tax system. Policymakers need to take account of economic, administrative, international, and behavioural factors. Looking in isolation at one tax provision or even one type of tax can lead to poor tax policy choices and sub-optimal economic and social outcomes (Brys et al., 2016; Slemrod and Gillitzer, 2014; Slemrod and Robinson, 2010).

2.1.3 Affecting pre-tax behaviours and opportunities

The tax system should provide incentives to activation, especially to the categories of workers that are least attached to the labour market. Targeted reductions in social security contributions (SSCs) and well-designed earned income tax credits (EITCs) have proven to be effective means of encouraging labour market activation (OECD, 2011b). EITCs and SSC reductions that lower the labour tax wedge and therefore raise after-tax earnings are particularly effective for workers that tend to have high labour
supply elasticities including young and older workers, women and the low-skilled. Policymakers should focus design of EITCs and other in-work benefits as well their integration with other labour market policies such as minimum wages, and the levels and eligibility conditions of unemployment benefits (Immervoll and Pearson, 2009).

The tax system can become more gender-friendly. Second earners are often taxed at high marginal rates relative to primary earners, due to family-based-taxation, spousal allowances, and family based benefits (Figure 19). In most countries, second earners are more likely to be women. Women often have particularly strong negative responses to income taxation (OECD, 2011b). The tax system, in concert with other policy approaches, should do more to provide incentives for women to work, such as removal of spousal allowances, targeting tax concessions at second earners and levying personal income taxes on an individual basis. This is especially the case for households with children (Thomas and O’Reilly, 2016).

Figure 19. Tax rates are higher on second earners than on single tax payers

Source: “The Impact of Tax and Benefit Systems on the Workforce Participation Incentives of Women” (Thomas and O’Reilly, 2016). The primary earner is assumed to earn the average wage.

Tax policies to reduce informality are also vital to achieving inclusive growth. Reducing informality improves efficiency and stimulates economic growth as formal sector businesses tend to be more productive. Workers employed in the informal sector have limited access to social protection, are typically offered inadequate contracts and earn comparatively lower wages, and are more vulnerable when they lose their job or when they retire. Improved tax compliance and enforcement should be combined with incentives to formalise, including using low rates, simplified registration processes, simplified tax and administrative systems and by reduced red tape (OECD, 2016e).

2.2 Improving the effectiveness of social protection transfers

2.2.1 Providing space to help marginalised workers return to the labour market

The size and structure of social protection are major drivers of the effectiveness of inclusive growth strategies. On average across G7 countries, social spending, including for health, accounts for 51% of government spending (45% on average across the OECD as a whole). Budget allocations for effective social protection can promote inclusive growth, but achieving it requires progress on several crucial items in the social protection agenda. This section focuses on out-of-work transfers as one instrument to promote labour market inclusiveness.
Accessible and well-designed out-of-work benefits should be put in place to make layoffs less costly for workers. Recent evidence has pointed to declining benefit coverage as one driving factor of growing income inequality since the mid-1990s (OECD 2011a; forthcoming c). Accessible income support for job losers also reduces the demand and need for stringent employment protection legislation and thereby facilitates the movement of labour to emerging, high-productivity activities (OECD, 2007). To avoid that benefits prolong unemployment or contribute to job instability (Boeri et al., 2015, OECD 2015b) and to ensure that benefits accelerate re-employment with a good match between skills and job requirements, out-of-work benefits should:

- **Be made accessible to all jobseekers, including those with intermittent employment spells.** In around half of OECD countries, fewer than 50% of active jobseekers receive unemployment support (OECD 2016f). The coverage rate of lower tier safety nets, such as minimum-income benefits for the poor, is typically smaller.

- **Be fully designed to be employment-oriented, boosting job-search incentives and reducing the scope for misuse.** Practical solutions include waiting periods that delay the first benefit payment help to ensure that job-search incentives remain intact during the early phase of the unemployment spell and even before job loss; reducing benefit levels at later stages of unemployment, or less generous assistance benefits following expiry of unemployment insurance; effective monitoring of job-search activity requires strong and well-resourced employment services serving all jobseekers (Langenbucher, 2015). Germany and the United Kingdom are among G7 countries with considerable experience in providing accessible job-search assistance irrespective of the type of income support unemployed people receive, by ensuring close institutional links between employment services and benefit administrations (Immervoll and Scarpetta, 2012; OECD 2015b).

Governments should also support employment efforts and career advancement of low-skilled and marginal workers in particular. New OECD work suggests that, for the majority of people on the margins of the labour market, work incentives are not the main or the only obstacle (see Section 3.2), low or outdated skills standing as the largest barrier. Access to life-long learning is, however, typically most difficult for low-skill individuals (Figure 20). Because employers have a good sense of their skills needs, subsidies for training existing employees are most often paid to employers. However, targeting training directly to workers, often referred to as “retention and advancement” programmes, can increase their chances of retaining their existing job or moving to a higher quality one. Evidence from existing programmes (e.g., the WorkAdvance programme in the United States, targeted training in Germany for workers employed in professions that are unrelated to their qualifications), shows that these programmes often target skills or occupations that are highly demanded.
2.2.2 Adapting pension systems to the new realities of ageing populations and low income growth and returns

Reforms to make the pension system sustainable from a public finance perspective often entail lower replacement rates which will transmit wage inequalities into retirement income inequality. Population ageing strains defined benefit pension systems. Defined contribution schemes by construction avoid financial sustainability issues, but higher longevity raises the price of converting pension assets into a stream of pension benefits, thereby generating pension adequacy issues. Recent pension reforms in many OECD countries, including France and Italy, mainly aimed at improving the financial sustainability of pension systems by aligning pension benefits more closely to earnings history. This however entails lower replacement rates, which will effectively increase the transmission of wage inequality into retirement income inequality. First-tier old-age pensions - the first layer of protection of the elderly within the pension system including social assistance, basic pensions and minimum pensions - might therefore play a bigger role for retirement income adequacy and prevention of poverty among retirees.

Countries with high old-age poverty rates need to strengthen their old-age safety-nets, though price-indexation remains a challenge. OECD (2016f) shows that there is large scope for augmenting old-age safety-nets in countries where poverty elderly is large. Moreover, first-tier pensions are adjusted in line with prices in many G7 countries (Canada, France, Italy and the United States), which means that retirees – from one generation to the next at the time of retirement and within generations during retirement - will increasingly lag behind workers’ living standards in the long term. Price indexation of first-tier pensions might be a smooth way to lower their levels in countries where they are considered too high but would also put strong pressure on public finances.

Increasing the amount of contributions by increasing retirement ages or higher contribution rates will sustain pension levels and have positive spillovers on public finances. Low productivity growth and prolonged low and negative interest rates also pose challenges for pension funds and financial institutions offering life insurance policies that promise fixed nominal returns based on outdated
economic fundamentals (OECD, 2016f). A fall in the discount rate increases the present value of the liabilities of defined-benefit pension funds and life insurance companies, undermining their solvency. To counter that, higher contributions are needed either through higher contribution rates or higher retirement ages or both. This would also improve finances.

To avoid that higher statutory retirement ages hurt disadvantaged people, health and labour market policies are needed to ensure more inclusive participation at older ages. Higher contribution rates raise marginal effective tax rates, which may lead over time to lower wages and higher unemployment depending on how the labour market adjusts. This is why increasing retirement ages to stabilise the number of years spent in retirement relative to that spent working is the best policy option. However, higher statutory retirement ages might hurt disadvantaged groups who have less employment opportunities close to retirement. This highlights the importance of implementing inclusive health policies (section 3.1) and labour market policies for a more inclusive participation at older ages (OECD 2016g).

2.2.3 Adopting a counter-cyclical stance on social investment and protection spending

From an inclusiveness perspective, maintaining accessibility of key areas of social protection during recessions is of greater urgency when the demand for support increases during downturns. Several G7 countries increased social support for working-age people in a strongly counter-cyclical manner following the global financial crisis (e.g., United Stated, Japan, see Figure 21). But in some others, including a number of EU countries, important categories of social expenditures have been pro-cyclical in the recent 10-15 years, with spending arguably not keeping pace with the additional need for support during downturns. When spending increases during years of stronger economic growth are larger or similar, this diminishes the space for cushioning the negative consequences of subsequent downturns at the macro levels and for affected households. Such pro-cyclical patterns of social spending may reinforce the income gaps that open during recessions and, through the scarring effects of poverty and unemployment, can contribute to longer-term inequality trends (OECD 2014b).
Efforts should be made to make social protection spending more counter-cyclical. In particular these require:

- **Consistency of cyclical adjustment built into the revenue and spending side of the budget:** A failure to address fiscal misalignments during economic upswings creates strong pressures to consolidate in a pro-cyclical manner, which risks delaying and slowing the recovery. A study of 17 OECD countries confirms the pattern of pro-cyclical consolidation and points out that large fiscal adjustment programmes have almost always taken place in the context of “initially weak [macro-financial] fundamentals” (Dell’Erba et al., 2013).

- **Striking the right balance between benefit recipients’ rights and responsibilities, with a view of making transfers more responsive to labour-market conditions.** Job-search requirements and activation measures help ensure that benefit expenditures decline when labour demand picks up. They also allow benefit administrations some room for manoeuvre to make benefits more accessible (e.g. by tailoring eligibility criteria to labour-market conditions) when job prospects are poor or when increasing numbers of jobseekers have no recent work experience. Moreover, activation policies contribute to better targeting by making support conditional on job-search efforts (Immervoll, 2012; OECD, 2013a). If well designed, such targeting can, in turn, create the
fiscal space, and possibly the political support, that is needed to ensure support for individuals and families who require it.

- **Actively adapting unemployment benefits and employment support to the labour-market situation.** There is, for instance, a good case for extending benefit durations (in countries with otherwise short maximum duration) during recessions, when job-search durations are long and large-scale restructuring requires jobseekers to move between across sectors or regions and acquire new skills (Faber and Valletta, 2015). Some G7 countries, such as France and the United States, have actively extended certain out-of-work benefits at the onset of the GFC, while Canada has considerable experience with linking unemployment benefits (*Employment Insurance*) to province-specific unemployment levels.

### 2.3 Spurring regional development by increasing the impact of spatially-targeted fiscal expenditures

**Inclusive growth is not possible without improving the economic performance of those regions, cities and neighbourhoods lagging behind.** While GDP per capita differentials across G7 countries have remained stable over the last few years, income disparities within G7 countries have widened. The same trend is found among metropolitan areas, as incomes per inhabitant in large cities are converging across the OECD, while city incomes within countries are diverging.

**Improving the productivity performance of lagging regions can address stagnant national productivity growth and generate greater inclusion.** As observed at firm level (see section 2.4), the OECD average country displays a widening productivity gap between top and bottom regions. Around one in five persons in the OECD area is living in regions with productivity growth rates significantly below the national productivity “frontier” regions.

**Firms that move to the tradable sector have the potential to catch-up significantly the regional gap but need specific transition policies that can offer guidance and support to compete on international markets.** One of the characteristics associated with the catching up of lagging regions is growth in the tradable sector, a finding true for both urban and rural regions alike. While trade helps lagging regions to catch up, companies often lack skills and other resources needed to be internationally competitive. Policies, such as that of the Trade Adjustment Assistance Programme in the United States, can accompany to the transition providing professional guidance and various adapted business services.

**While G7 and other OECD countries have progressively shifted their spatially targeted fiscal expenditure from subsides to investments, more must be done to improve the effectiveness of this investment.** Regional development policies used to rely on redistribution and subsidies, whereas they now focus on supporting the growth potential of all regions through investments (OECD, 2009; OECD 2016h). Indeed, in the past many countries designed subsidy-based interventions to reduce regional disparities, in the forms of tax incentives for firms to locate in specific areas or employment subsidies for firms in those locations. However, regional redistribution on a massive scale is often not sustainable because it creates relations of dependency and, over time, the richest regions become increasingly reluctant to finance the lagging ones. This is also the case of rural development policies, which could be more effective in providing better conditions for regional growth in G7 countries if they went beyond farm supports to recognise the diversity of different rural economies and the importance of connectivity to dynamic areas.

**Urban development policies must focus on spatially-targeted business development while avoiding crowd out private business efforts.** A range of policy tools are used for place-based efforts, focused mainly on business development and transport infrastructure, among other instruments (*Figure 22*). In
terms of business development, policies may be more effective if they are adapted to the specific needs in a particular place, or complement those interventions that de facto favour leading firms or leading regions. Cluster-type policies are a popular form of business development initiative at both national and regional levels to support innovation and growth in the particular places where the “cluster” is located. In some cases simple local tax incentives may also be provided for capital investment or employment as long as they are well targeted on areas experiencing high unemployment. An example of this is provided by the local enterprise zones (Box 4). However, evidence points to the need for spatially-targeted business development policies to avoid undesirable effects whereby public funds simply substitute for private funds (OECD, 2007).

Figure 22. Use of policy tools in regional development policy: OECD countries

Note: Figures based on 30 countries responding to the survey question.


Box 4. Local enterprise zones: a common tool for spatially-targeted fiscal expenditure

One of the potential policy levers for inclusive growth available to G7 countries is the award of highly spatially targeted fiscal incentives to businesses for capital investment and employment. A number of G7 governments have experimented with this type of approach in recent years. Current interventions include business rate reductions in enterprise zones in the United Kingdom, corporate tax incentives in distressed urban neighbourhoods in France, and the Federal Promise Zones and many state-level local tax incentive programmes in the United States.

The evidence on the impact of enterprise zones is mixed and potentially affected by the contexts in which they operate and features of their design. Nonetheless, several evaluations have shown that enterprise zones can be effective in relieving local concentrations of unemployment and stimulating local growth in the right circumstances (e.g. Busso, Gregory and Kline, 2010; Ham et al 2011; Gobillon et al, 2010; PACEC, 1995).

Potential problems with such policies are that they may occasion significant deadweight or windfall effects for beneficiary firms, generate significant displacement from other areas of high long-term
unemployment or benefit people not experiencing long-term unemployment. The detailed design and location of the policy intervention is likely to be critical in these respects. In particular, governments need to target policy carefully so as to avoid supporting existing activities or relocations from other high-unemployment areas and focus incentives on places that combine local distress with local economic potential.


Regional development policies and local programmes can also usefully complement structural reforms maximising the impact of the latter. Pro-growth structural reforms affect leading and lagging regions differently. For example, pro-growth product market regulations will have a greater impact on those regions with a greater specialisation in the economic sector being regulated. Labour market regulations, measured by indicators of employment protection, have a potentially stronger effect on rural regions because of their smaller labour markets. Improved transport options increase the effective size of a local labour market and can complement a particular labour market reform to increase its impact (OECD, 2016h; D’Costa, Garcilazo and Oliveira Martins, 2013). Many of these issues, particularly for low-skilled workers, may involve efforts to tailor worker training to the needs of firms located in the area.

Education is another area where local and regional governments shape inclusive growth prospects and schools in poorer communities do lack financial resources needed to fully succeed. On average across OECD countries, regional or local governments account for 60% of funding for primary, secondary, post-secondary and non-tertiary education. The role of subnational governments is even more important in the United States (100%), Japan (98%), Canada (97%) and Germany (94%) (OECD, 2016i). More tailored responses to the needs of local schools, typically through greater use of autonomy and accountability, have a positive impact on students’ performance (OECD/KIPF, 2016). However, given the degree of discretion by subnational governments, there is potential for inequitable distribution of resources across schools and local jurisdictions that could influence student outcomes. One of the main reasons for this is because schools’ capacity to generate additional revenues is often influenced by the socio-economic composition of their local communities that they belong to. Unless the local government ensures additional resource allocation to disadvantaged schools, schools located in poorer communities can suffer from lack of resources due to their low capacity to generate additional revenue (OECD, forthcoming d).

Beyond education, regional and local governments have an important role to play in lifelong learning strategies, which affect not only productivity but also inclusiveness. Across the OECD, apprenticeships and other work-based learning opportunities are increasingly being used to better link individuals to good jobs. Local governments can contribute by forging partnerships between the education system and employers. Local and regional governments can also take action to increase the amount of training places offered. In 2015, the UK government announced that it will take the number of apprenticeships offered by prospective contractors into account when deciding how to award large public contracts. In some cases, Local Authorities have attached conditions to public procurement contracts to consider skills development opportunities that can be offered to young people (OECD, 2016j). Other municipalities in

40
OECD countries have also moved to introduce social clauses into their public procurement processes with the goal of adding human resource management considerations (OECD, 2014c). The devolution of national powers to local regions in England has allowed city areas to independently develop and implement apprenticeship and skills policies (Box 5).

**Box 5. Local apprenticeship hubs in the United Kingdom**

There has been a recent push to increase the number of apprenticeships in the United Kingdom at both the upper secondary and post-secondary levels. Apprenticeships have received significant policy attention in recent years. In England, the number of apprenticeship registrations has doubled since 2010. The recent establishment of new local institutional structures (e.g. Combined Authorities) and the devolution of funding and greater responsibility to local areas to support economic growth (e.g. via City Deals/ Local Growth Deals) is providing new opportunities for cities to lead, shape and implement skills strategies. For example, as part of the City Deal process, Manchester decided to invest in skills, with a priority focus on apprenticeships. A new Apprenticeship and Skills Hub was set up there in 2012-13 with a budget of GBP 6 million to increase the number of people taking apprenticeships at level 3 and above, and to support apprenticeships within SMEs.


For place-based policies, governance arrangements (the “how”) are also essential for effective implementation. Above and beyond the quality of government, the organisation of government intervention is critical for increasing the impacts of these spatially targeted policies for both productivity and inclusion (see Chapter 3). Reforms of subnational government are undertaken in many countries to bring policy to the relevant scale for investment and service provision. Of particular importance is the need to foster policy co-ordination across sectoral areas, vertically across levels of administration, and horizontally among jurisdictions at the same level of government. The *OECD Recommendation on Effective Public Investment Across Levels of Government* and its accompanying toolkit for implementation recognise the importance of governance for effective implementation.
ENHANCING PUBLIC SERVICES EFFICIENCY FOR ACHIEVING INCLUSIVE GROWTH

A pro-inclusive growth agenda in the area of public services should include measures to improve the efficiency and effectiveness of social spending. As noted in Chapter 1, evidence suggests that fiscal transfers (as opposed to taxation) have been the main driver behind the decline in the redistribute impact of fiscal policy over the last two decades. Governments should introduce greater efficiency and flexibility in social services by prioritising interventions that offer the biggest “bang for the buck” and better targeting the people and places most in need, in particular by focusing on a series of early and specific investment-related social policies on education, labour markets and health care which have the greatest potential from an inclusive growth perspective. While the current fiscal space allows for greater spending in many G7 countries, it is critical to channel additional spending into productive investment and ensure that the results of this investment are efficient. Spending on well-targeted services may translate into overall savings if reduced capacity and quality reduce the demand for cash support or for services in other areas.

3.1 Improving education of disadvantaged students

Public social spending is a major instrument in G7 countries but a large part of it does not expand the productive potential of individuals. In 2016, public social spending averages an estimated 21% of GDP across the 35 OECD countries. G7 countries – except for the United States – spend above the OECD average proportion of their GDP on public social spending. In addition, compared with pre-crisis levels in 2007, public social-spending-to-GDP ratios have increased on average 3 points across G7 countries in 2016 (Figure 23), though the benefits of this expansion have not, by and large, gone to young and working age individuals who may have the potential to transform at least part of additional social spending into enhanced productive capacities. The public provision of services, or the public support of private provision, is also an effective way of making important aspects of life less dependent on income. Accessibility is crucial, but the distribution and quality of provision must be at the heart of government strategies in these areas, and this requires systematic monitoring and evaluation (OECD, 2015c, forthcoming a and d; Dutu and Sicari, 2016).

Figure 23. Public social spending is worth 22% of GDP on average across the OECD

Public social expenditure as a percent of GDP, 2007, peak level after 2007, and 2016

Source: Society at a Glance (2016)
Investment in education, especially for young children and those from disadvantaged backgrounds, need to be prioritised for building equitable and inclusive societies. Socioeconomic outcomes build up from childhood to adulthood. For example, childhood circumstances affect later life health, as future labour market conditions and career progression. Fighting inequality early therefore has the greatest returns, both privately and socially.

Countries that ensure children from socio-economically disadvantaged backgrounds have a strong start early in life are more successful in reducing the gap in learning outcomes between advantaged and disadvantaged students. Research shows that the cognitive, social-emotional skills developed during the first years of life set the basis of future potential (OECD, 2015c; forthcoming a). Social-emotional skills are critical in determining the well-being and life outcomes of children and young people, affecting the extent to which they will be successful in school, gain employment, achieve economic security, enjoy good health and contribute positively to their community (OECD, 2015c; forthcoming a). Although early learning deficiencies can be overcome, inadequate learning environments and a lack of support can impede various developmental needs and have lasting impacts on individuals later in life (OECD, 2015c; forthcoming a). As children from low socio-economic backgrounds are far less likely to benefit from high-quality home learning environments and early childhood education and care services (ECEC) than their more affluent peers, the following targeted policies need to be considered in order to ensure quality learning opportunities for children from disadvantaged backgrounds:

- **Removing barriers to ECEC**: Children from disadvantaged backgrounds are more likely to experience many barriers in accessing quality ECEC facilities. These barriers include costs, proximity, availability of quality ECEC facilities, and lack of information on ECEC services.

- **Supporting family and community-based interventions**: Evidence-based parenting programmes, home visits for troubled families and subsidies to boost income can help disadvantaged families improve the learning environments they provide for their children.

- **Providing opportunities to develop socio-emotional and cultural skills**: Programmes that focus on training dedicated to improve parent-child interactions and parenting styles have been successful in improving young children’s socio-emotional outcomes, particularly for disadvantaged families.

Better education performance often owes more to the quality of policies than to the level of spending. The influence of socioeconomic background on education skills is large in some OECD countries, and there are large differences across countries in the PISA scores of the poorest-performing students. The OECD has identified key education policies to reduce school failure and avoid that social circumstances stand in the way of achieving educational potential (OECD, 2012), these include: eliminate grade repetition; avoid early tracking and defer student selection to upper secondary; manage school choice to avoid segregation; make funding strategies responsive to students’ and schools’ needs; and design equivalent upper-secondary education pathways to ensure completion. These policies may critically improve the efficiency of public spending in education.

Disadvantage is not only related to children’s socioeconomic background but also to their learning environment. To help low-performing disadvantaged schools (OECD, 2012) countries can strengthen and support school leadership; stimulate a supportive school climate and environment for learning; attract, support and retain high quality teachers; ensure effective classroom learning strategies; and prioritise linking schools with parents and communities.
3.2. Ensuring a smooth education-to-work transition

Promoting a smooth school-to-work transition is an essential part of inclusive growth strategies. Joblessness in the early stages of working lives can have long-term scarring effects on career and earnings prospects (OECD, 2013b). Fighting early school leaving is essential for youth at-risk through: systematic monitoring of school attendance; comprehensive support for at-risk students and their families; after-school programmes; and flexible schooling environments (OECD, 2016k). Back-to-the-classroom strategies might prove counterproductive for disconnected youth who cumulate disadvantages; training programmes taught outside traditional schools, combined with regular exposure to work experience and adult mentoring, are often better strategies (OECD, 2010b). Remedial education is needed for school drop-outs.

Apprenticeship and other high-quality vocational education and training (VET) programmes facilitate successful school-to-work transitions. Best practices in this respect include Austria, Germany and Switzerland. But other countries should enhance existing VET and apprenticeship programmes and secure access of VET students and apprentices to good jobs (OECD, 2010b). VET is valuable because it prepares young people for the labour market with a view to responding to employers’ skills needs. Pre-apprenticeships can help young people who are not yet ready, while the emphasis on career guidance helps ensure that students make the right choices (OECD, 2016k).

Adequate income support to unemployed youth should be provided subject to strict mutual obligations. However, successful programmes for young people with severe or multiple barriers tend to be intensive and expensive (OECD, 2016k). The most promising programmes combine schooling and practical training with counselling, psychological support and housing. Some have been shown to be cost-effective, by raising earnings potential and reducing criminal behaviour.

3.3. Improving health spending efficiency and tackling health inequalities

Governments should diagnose and monitor the fiscal sustainability of their health systems, focusing on tools that can help control health care expenditure growth and promote greater sustainability of health care spending, while fostering access and quality of health care. Public health spending in OECD countries has grown rapidly over most of the last half century. It is above 10% of GDP in all but two G7 economies and it is over 9% in Italy and the UK. In the OECD as a whole this ratio is projected to rise by an additional 2 percentage points of GDP over the next 20 years. The global financial and economic crisis which started in 2008 led many OECD countries to develop and implement strategies to control or reduce spending. Under this context, some countries reduced services across-the-board and potentially leading to poorer health outcomes and financial hardship from increasing costs borne by patients (OECD, 2015d).

Improving the efficiency of health care spending is also important from the perspective of making fiscal policy an instrument for inclusive growth. In particular, well-designed prevention policies are generally effective to improve health even though they are not imminently cost-effective. The share of health spending allocated to prevention is only around 3% on average in OECD countries and should be expanded by targeting key risk factors and population groups (Devaux and Sassi, 2015). The best prevention policies are multi-intervention strategies that include a mix of public awareness campaigns, regulations (e.g. regulations of advertisements and sales of unhealthy products), taxation and counselling by general practitioners.

Prevention policies have also the potential to reduce health inequalities, but they need to be well-designed to reach the most disadvantaged groups. People in lower socioeconomic groups are indeed more likely to smoke, to be heavy alcohol drinkers (particularly men) and to be obese, all important risk factors for many diseases and causes of death. They could therefore benefit more from prevention policy
aiming to tackle harmful alcohol consumption (OECD, 2015d) and obesity (Devaux and Sassi, 2015). Whether prevention actually reduces SES-related health inequalities depends on the specific policies and programme design. Broad health promotion campaigns often fail to reach the most disadvantaged socio-economic groups. By contrast, fiscal measures, such as taxes on certain products or substances which are identified as being unhealthy, have been found to be the only intervention producing consistently larger health gains among poorer groups due to a greater response to price changes (OECD, 2010c).

**Health services should become more accessible and more affordable for the low-income groups.** Cost effective prevention, primary care and screening services should be provided for low or no cost to prevent diseases or detect them early. However, inequalities exist even when screening services are provided free of charge: people with low level of education or income are less likely to take part in screening programmes. This means that policies need to tackle non-financial barriers, such as lack of awareness of potential benefits, waiting time and distance (Devaux and de Looper, 2012).

### 3.4. Enhancing the efficiency of social protection systems by improving their targeting

**The access to social protection systems to the neediest individuals need to be further expanded.** Although social protection systems in all G7 and other OECD countries feature some forms of targeting to low-income groups, higher-income groups sometimes receive large shares of support (Figure 24) as benefit entitlements reflect earning-based contributions and targeting to low-income groups is limited to avoid possible low-income traps. Limited support for the least well-off, however, signals that basic forms of protection are difficult to access, and that reforms should make effective protection of the least well-off a priority. These reforms should at the same time minimise targeting costs, as poverty traps and financial disincentives to work (see below).

![Figure 24. Existing cash support to the poor must be strengthened](image-url)

Cash transfers received by working-age individuals in low- and high-income groups, 2013 or latest year available

<table>
<thead>
<tr>
<th>Country</th>
<th>Poorest 20%</th>
<th>Richest 20%</th>
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<tr>
<td>New Zealand</td>
<td>250</td>
<td>200</td>
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<tr>
<td>Netherlands</td>
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<td>150</td>
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<td>France</td>
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<td>United Kingdom</td>
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<tr>
<td>Germany</td>
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<td>0</td>
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<tr>
<td>Canada</td>
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<td>-50</td>
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<tr>
<td>Mexico</td>
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<tr>
<td>Norway</td>
<td>-100</td>
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<tr>
<td>Spain</td>
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<td>Portugal</td>
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<td>Turkey</td>
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<td>Greece</td>
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<td>Canada</td>
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<tr>
<td>Mexico</td>
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<td>Norway</td>
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<td>Spain</td>
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<tr>
<td>Greece</td>
<td>-200</td>
<td>-250</td>
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</tbody>
</table>

Notes: Age group 18-65, 18-62 in France. Public social cash transfers at the household level, adjusted for household size. Income groups refer to disposable incomes.

Source: Calculations based on the [OECD Income Distribution Database](https://stats.oecd.org/).

The design of social protection should seek to support vulnerable groups at all points of the economic cycle. The central role of assistance programmes, as crucial fall-back options for those without any other resources, should be reflected in the design of social protection reforms. Effective last-resort safety nets in all areas of social protection reduce the risk that necessary policy reforms produce unintended losses.
and economic hardship for vulnerable households. They also make existing social protection systems better prepared to provide timely support in the wake of major downturns such as those following the global financial crisis. And well-targeted safety-net benefits are also more cost-effective than other common measures towards poor households, such as for instance tax breaks for food or energy that are harder to target. In the context of ongoing labour-market transformations and emerging new forms of work, social safety nets provide a crucial backstop to social protection strategies that need to adapt to far-reaching, but still partly uncertain, employment and earnings trends.

Greater reliance on means testing helps to target and protect the most vulnerable while reducing benefit expenditures. The size of mean-tested programme is relatively small in many countries and there is room to expand it, by either making those programmes more generous or by extending their coverage. While the balance of these options may vary across countries, means-tested programmes are known to be difficult to roll out quickly and to suffer from low benefit take-up. While means testing may in principle weaken work incentives, recent OECD analysis suggests that they do not hamper employment as much as other factors such as low work-related skills or care responsibilities. Evidence also suggests that financial incentives to work are a less decisive driver of employment outcomes and overall earnings during an economic downturn when labour demand is weak (Immervoll, 2012).

Means-tested programmes need to be designed carefully however and in some case they ought to be targeted to non-income characteristics or behaviour rather than income. Financial disincentives associated to means-tested programmes are a pressing issue for some population groups. In these cases, targeting behaviour or non-income characteristics is an alternative to traditional income testing that can save costs while leaving incentives intact:

- When support is directed at children, it can help to ensure more equal opportunities and reduce the likelihood that poverty is transmitted from one generation to the next. For instance, subsidised or free school meals exist in a number of OECD countries, including France, the United Kingdom, and the United States (Richardson and Bradshaw, 2012).

- Well-balanced “mutual obligations” help to target support to intended recipients while strengthening incentives to work and look for jobs (this is explored further below in section 3.1.4. in the discussion labour markets).

- Support that is conditional on employment, in the form of in-work cash benefits or earned-income tax credits, combines redistribution to lower-income groups, with stronger financial incentives for some population groups. In-work benefits are therefore well-placed to leverage, rather than replace, people’s initiative to improve their income situations. They have been shown to work especially well when wage disparities are substantial (Immervoll and Pearson, 2009).

- Other forms of conditional cash transfers (CCTs), such as those conditional on children’s regular attendance in school, formal ECEC services, children’s educational progress, and use of health services can also create positive externalities and ensure that income supplements are well-spent. They can also signal the importance of investment in human capital to beneficiary families. CCTs have been pioneered in middle and lower-income countries, but have recently been piloted in high-income regions as well, e.g., in New York City. To realise their potential as a valuable complement to more traditional forms of support, CCTs require a long-term strategy supported by a willingness to test and adapt different policy designs (Riccio, 2013).

It is imperative to adapt social protection targeting strategies to new labour-market realities and the Future of Work. Blurring lines between different forms of employment, but also between working and
not working, create challenges for effectively linking benefits and services to particular statuses, such as specific patterns of employment or job search. As a result, trends and uncertainties regarding the Future of Work also raise questions on the “Future of Social Protection”. If targeting becomes more difficult, existing strategies tying support largely to employment or income may need to be reviewed or adapted. Governments can, for instance, invest more into regulation, information and monitoring in order to maintain effective conditionality and safeguard the functioning of existing targeting strategies. Moving towards greater universality is an alternative option for keeping social protection accessible. But, for a given level of support, this would cost significantly more and requires careful considerations of the patterns of gains and losses associated with moving away from traditional forms of targeting and conditionality (OECD, 2017 forthcoming e).
The role of business dynamism and competition in fostering inclusive growth

Fiscal policies geared towards the creation of a level playing field for firms can boost Inclusive Growth. Certain aspects of business taxation and subsidy systems in G7 countries can unintentionally inhibit a level playing field between young firms, SMEs and incumbents. These distortions may drag on growth by impeding the entry and development of new innovative firms, reducing competition and diverting resources from their most productive and innovative uses. They may also discourage the formalisation of small businesses, an important driver of inclusion, and reduce returns to lower paid workers and owners. Changes in the international tax environment create new opportunities to reduce inequality without reducing growth. Since avoidance and evasion in the international tax system disproportionately benefits those with higher incomes and wealth, these changes create tax policy opportunities to reduce inequality as well. Continued implementation of the BEPS recommendations and strengthening of the system of information exchange for tax purposes is crucial in realising these opportunities. Fiscal policy should also be accompanied by sound structural policies to make Inclusive Growth happen. While fiscal policy can have a strong influence on making growth trickle down, it cannot alone suffice to generate an economic environment that underpins strong productivity growth. Framework conditions and structural reforms that aim at unleashing competition among firms and sectors are also needed, to ensure efficient allocation of productive factors in the economies, domestically and internationally. This chapter discusses some of these policies together with fiscal instruments that have a potential for shaping the playing field across firms.

4.1. Reinvigorating Business Dynamism will call for concerted action in competition, regulatory and skills policy

Since the late 1990s, there has been a widespread decline in the pace of business creation and business dynamism more generally (Calvino et al. 2016, Blanchenay et al., 2017). The share of non-viable old firms has been increasing in OECD economies, particularly since the financial crisis, and the productivity of this group has been falling rapidly relative to “viable” old firms and relative to younger firms in general. Most of these trends have been observed not only at the global level, but also among firms within countries and sectors (Andrews et al., 2016). Recent work on 14 OECD economies (Berlingieri et al. 2017) has found evidence of increasing differences in the performance of the most productive and least productive firms. The analysis also shows how the dispersion in productivity has generally grown faster in the lower half of the distribution, particularly in the early years of the decade.

The apparent decline in business dynamism calls for cross-cutting policy intervention. As noted in Chapter 1, the dispersion in firms productivity performance is large and growing and can have important implications for the inclusiveness of our economies (Berlingieri, Blanchenay and Criscuolo, 2017), not least because the policy settings that affect the extent of productivity dispersion also likely have implications for wage inequality. Correspondingly, policy has a vital role to play in boosting growth by promoting market competition and levelling the playing field, especially in services which are generally more sheltered from international markets, and in certain ICT intensive sectors characterised by network externalities, where market concentration may be growing. Competition creates better conditions for growth-enhancing reallocation through the entry of more productive businesses and the exit of less successful ones. In this context, the rise in productivity divergence between the leading firms and the rest is much more marked in sectors where the pace of pro-competition product market reforms was slowest
(Andrews et al., 2016). Complementary evidence points to an additional beneficial role of enhanced competition through lower regulatory barriers to firm entry: it contributes to job-creation through a larger number of young companies with fast growth potential (De Serres and Gal, 2017; Criscuolo, Gal and Menon, 2014), and a stronger post-entry growth performance of firms (Calvino, Criscuolo and Menon, 2016).

Reviving labour productivity growth requires intervention on several fronts. Framework policies other than product market regulation affect aggregate productivity through their impact on the capacity of the economy to allocate capital and labour resources to fast-growing sectors (OECD 2017b). These policies include: \(i\) reducing barriers to foreign competition (in line with efforts at domestic level); \(ii\) increase the efficiency of R&D and innovation policies (see also next section); \(iii\) promoting the efficiency of public administration and the quality of public services; \(iv\) enhancing the provision and the quality of physical infrastructure; \(v\) strengthening the rule of law and \(vi\) reforming the regulation of the financial sector to spur new lending and reallocation of capital to more productive firms.

Action to address skills mismatch in G7 countries would also help to foster stronger productivity growth. The use of skills in the workplace is a major determinant of cross-country differences in labour productivity. On average across countries, roughly 15% of workers show skills mismatches, with over-skilling being more prevalent than under-skilling (Adalet McGowan, M and D. Andrews, 2015). However, it should be taken into account that the pool of people with very low skills are more likely to be unemployed, so a large proportion of them will not be part of this picture (which only includes people at work), but this may impose serious constraints on economic growth and is without any doubt the greatest source of inequality. While over-skilling might be good from the point of view of a single firm, misallocation between skills and jobs lead to aggregate productivity costs because it prevents the optimal use of workers’ capabilities. Indeed, a more efficient use of human talent in countries where skills mismatch is very high could boost the levels of labour productivity by around 10%. This could close about one-fifth of the gap in labour productivity between Italy and the United States (OECD, 2015e). A better matching of skills and jobs will require integrated education and labour market reforms. Particular emphasis should be placed on the aim of improving the quality of education systems, incorporating horizontal skills, achieving a better match between the needs of global labour markets and what students learn, and improving managerial quality. Framework policies that affect firm entry and exit and the efficiency of matching in labour markets are key. For instance less cumbersome product market regulations and bankruptcy regulation that does not punish excessively business failure are associated with lower skill mismatch. Less stringent employment protection legislation for youth and policies that promote residential mobility may also prompt a better skill matching.

In parallel, OECD analysis shows that there is much scope for regulatory reforms, particularly to insolvency regimes to boost labour productivity. OECD work (Adalet McGowan, Andrews, Millot, 2017) notes that regulatory reforms can help contribute to reinvigorated productivity growth by: \(i\) making it more likely that weak firms exit or are successfully restructured; \(ii\) reducing the share of capital sunk in lagging firms; and \(iii\) spurring productivity-enhancing capital reallocation. For example, reforming insolvency regimes to OECD best practice levels is estimated to reduce the share of industry capital sunk in lagging firms by around one-half in Belgium and Italy, which is significant given that the capital share of all of these firms in 2013 was relatively high at 14% and 19% in the two countries respectively. This analysis shows that less stringent product market regulations affecting firm entry and stronger rule of law and environmental protection stringency can also reduce the resources trapped in failing firms. At the same time, productivity in established small and medium-sized enterprises (SMEs) tends to lag behind large firms (OECD, 2016l), and policies targeted at overcoming barriers to their productivity growth can also help reduce productivity gaps with leading firms, such as business development services aimed at
upgrading managerial practices and business models, in-house workforce training and fostering ICT adoption. Such policies need to be designed carefully and targeted on tackling market and institutional failures.

**Young and small firms would benefit from better designed regulatory frameworks.** OECD analysis suggests that young and small firms are much more affected by poorly-designed regulatory frameworks than large and incumbent firms, limiting their opportunities for growth and reducing overall business dynamism. Calvino et al. (2016), for example, finds that the effects of less favourable access to finance, strict bankruptcy regulations, weak contract enforcement and civil justice efficiency, more strongly affect the growth dynamics of entrants than incumbents. The negative effect of these policy failures on start-up performance is particularly strong in highly dynamic sectors. Governments in a number of countries have taken initiatives to make product market regulations friendlier to young and small firms (Box 6).

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**Box 6. Canada’s Paperwork Burden Reduction Initiative (PBRI) & Red Tape Reduction Action Plan**

Canada has placed a great emphasis on regulatory simplification in recent times, first through the Paperwork Burden Reduction Initiative (PBRI) launched in 2004, and later through the Red Tape Reduction Action Plan, launched in 2012. One of the main objectives of the PBRI was to measure the cost of regulatory compliance for small businesses. Three surveys were carried out between 2005 and 2011, which concluded that compliance costs had dropped by 0.3% per year over the period 2005-2011. In particular, the average “regulatory bill” was CAD 3 500 per business and CAD 370 per employee, i.e. 0.29% of business sector revenues, in 2011.

The aim of the Red Tape Reduction Action Plan is to reduce administrative burdens and improve the services and predictability of Canadian public administration for small business owners. As part of this Plan, Canada has introduced the “one-for-one rule” and “forward regulatory plans”. The first requires that new regulations increasing the administrative cost of doing business are compensated by the elimination of other regulations implying similar costs. The second is a description of future regulatory changes and proposals that a government department or agency intends to implement; the objective is to help business owners to adjust more easily to future changes in regulations.


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**Efforts also need to be undertaken to ensure that all firms have adequate access to finance.** Bank credit remains the main source of external finance for most small businesses, meaning that efforts should be pursued to make it easier for banks to lend to young firms and SMEs. Such efforts may include measures to improve risk mitigation which make use of new technologies for underwriting risks, including credit scoring models. This should also entail a push for effective and predictable insolvency regimes to ensure creditor rights and greater transparency for credit risk assessment. But efforts should also be made to foster the development of non-traditional forms of financing. For instance, initiatives such as crowdfunding and business angel activities have become increasingly significant, although they remain a small proportion of overall lending, and hold further untapped potential. Hybrid instruments, which combine debt and equity features, have also grown in prominence, increasingly serving both young and established companies that seek expansion capital, but which are not suitable for public listing. In each case, making full use of these instruments will entail a greater policy focus not solely on the supply of such financing methods, but also in fostering demand via concerted efforts to raise young firms and SMEs’ awareness and understanding of alternative financing instruments.
4.2. Governments need to ensure that business taxes and subsidies provide a level playing field for all firms

Certain aspects of business taxation and subsidy systems in G7 countries can unintentionally inhibit a level playing field between firms. In particular, compliance costs, asymmetric treatment of profits and losses, the distribution of taxation between capital and labour income and the design of R&D tax credits and incentives can all have distortive effects. These distortions may drag on growth by impeding the entry and development of new innovative firms, reducing competition and diverting resources from their most productive and innovative uses. They may also discourage the formalisation of small businesses, an important driver of inclusion, and reduce returns to lower paid workers and owners in small businesses. Tax preferences and simplification measures targeted at SMEs can help address the distortions, but they should be carefully targeted to ensure that they meet their policy objectives in a cost-effective way and do not create further distortions or complexities.

High costs of tax compliance fall disproportionately on small and young firms. Tax policy and tax administration arrangements have a direct impact on business creation, returns, resources and strategies. In particular, given a substantial fixed cost component to regulatory requirements and compliance costs (record keeping, filing and payment processes etc.) at national, regional and municipal levels, small businesses are placed at a disadvantage with respect to large enterprises. For young firms, which also tend to be small, high compliance costs can exacerbate the resource and cash-flow constraints often experienced in the early stages of business development, and may act as a deterrent to formalisation. In some cases, tax compliance costs for small firms may even exceed their tax cash payments (OECD 2015f; Eichfelder and Vaillancourt, 2014). For micro businesses in the United States, compliance costs can amount to 150% of net earnings (DeLuca et al. 2007).

Policies that simplify tax compliance can have important benefits for small firms and young firms. For example, in Italy, a presumptive tax is used to replace personal income tax, regional and municipal surcharges and regional production taxes for small businesses, in Germany very small firms are exempt from book keeping requirements for taxation, and in the United States SMEs benefit from exceptions to standard inventory accounting rules Table 1 (OECD, 2015f).
Table 1. Tax simplification measures for SMEs in G7 countries

<table>
<thead>
<tr>
<th>Single replacement tax regimes</th>
<th>Income tax simplifications</th>
<th>VAT simplifications</th>
<th>Other taxes</th>
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<tr>
<td>Presumptive taxes</td>
<td>Simplified accounting</td>
<td>Reduced filing</td>
<td>Exemptions</td>
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<td>requirements</td>
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<tr>
<td>Calculation VAT/GST liability</td>
<td>Simplified input tax credit calculation schemes</td>
<td>Cash accounting</td>
<td>Reduced frequency of filing</td>
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<td>Presumptive tax schemes</td>
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<td>Presumptive input tax schemes</td>
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<td>United States</td>
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Note: Shaded cells indicate the presence of the measure in the country.

Source: OECD (2015f), based on responses to an OECD Survey on the Taxation of Small and Medium-Sized Enterprises in OECD and G20 Countries, 2015. The survey aimed to identify the tax regimes that apply to SMEs in these countries.
Particular common features of business taxation systems tend to disadvantage young and small firms. The detailed design of taxation systems can also unintentionally disadvantage young and small firms. One of the issues concerns the asymmetric treatment of profits and losses applied in G7 countries. Typically, profits are taxed immediately, whereas if a firm makes losses they do not lead to a refund of past tax payments but instead reduce future taxes. This creates a disadvantage for firms in their early stages of development, when they are more likely to incur losses, posing cash flow problems which may affect the firm’s survival and growth. The deferred loss cannot be utilised by firms that do not recover. Another distortion arises because labour tends to be taxed more heavily than capital. Since SMEs tend to have more labour-intensive production processes than large firms (OECD, 2016m), this implies a higher tax burden on SMEs (OECD, 2015f). Taxation also has important effects on the cost and availability of finance for small businesses. Tax systems often give more favourable treatment to firms that access finance in the form of debt rather than equity. This discriminates against SMEs since they tend to rely more heavily on equity finance and internal funding (OECD, 2015f).

Special tax rules for SMEs can help level the playing field, but should be carefully targeted to avoid undue distortions. Many countries apply favourable tax treatment to SMEs. Special small business corporate tax rates exist in Canada, France, Japan and the United States, with firms under certain income thresholds eligible for lower tax rates if they meet certain other eligibility criteria. Depreciation preferences for SMEs, such as accelerated depreciation for certain forms of investments, are used in France, Germany, Japan, the United Kingdom and the United States and may be particularly helpful for young SMEs at the early stages of business development. Other preferences include more flexible loss provisions for SMEs. In Japan, for instance, SMEs can carry forward up to 100% of income, against 50% for large firms. There are also preferences aimed at investors in SMEs. For example, France offers a reduction in income taxes for investors in firms that are less than five years old and have less than 50 employees and turnover or balance sheet of less than EUR 10 million (OECD, 2015f). In Italy, a deduction applies to investors that is equal to the net increase in SME equity multiplied by a rate determined annually by the government (OECD, 2015f; 2017d). In Germany, there is an exemption from gift and inheritance taxes if the successor SME owner continues to hold the business (OECD, 2015f).

However, such rules may also have distortive impacts by giving businesses an incentive to remain small or split up into different firms. Preferences therefore need to be carefully targeted and designed. They should focus on overcoming the specific economic or tax difficulties experienced or providing support to firms providing positive spillovers to the economy. When a case for special tax rules exists, the use of tax preferences to redress the observed disadvantage should also be carefully considered against other options, such as targeted non-tax intervention or broader changes to the tax system or processes. It is also important to ensure that multiple preferences do not increase the compliance burden. A simpler general tax system may be more advantageous to SMEs than multiple measures that increase complexity (OECD, 2015f).
4.3. Governments also have an important role to play in investing in and incentivising research and development

Research and development spending and ownership of intellectual property is concentrated amongst leading firms. Evidence shows that very few firms account for a very large share of global R&D expenditure, patents and trademarks and those at the very top account for the greatest share. In 2012, among the world’s 2000 largest corporate R&D investors, the top 250 firms accounted for more than 70% of R&D and patents and 44% of trademarks amongst the group, whilst the top 100 firms the top 5% of the accounted for 55% of that group’s R&D expenditure, 53% of patents and 30% of trademarks.1

Governments have a key role to play in providing direct support and tax incentives for all firms to carry out R&D regardless of size. Governments support 10%-20% of business R&D expenditure in most OECD countries (OECD 2016n) through a combination of tax incentives and direct support. In all instances, it is important to ensure that supports are designed so as to be equally accessible to incumbent, young and new firms. At present, R&D support may favour incumbents and fail to fully benefit small and young innovative firms. G7 countries tend to offer support for business R&D through a mix of tax relief and direct support measures such as R&D grants and public procurement of R&D. Overall, tax incentives increased from 35% to 43% of total support for business R&D in the G7 area during the 2006-14 period (Figure 25) (OECD, 2017c). However, R&D investments are highly concentrated in large firms (from 64% in Canada, to 85% in the United States and 95% in Japan) and these firms also receive a large share of direct (78%) and tax support (72%) for business R&D in 2014 (OECD, 2016o).

Figure 25. Governments can play a big role to incentivise R&D efforts

Direct government funding of business R&D and tax incentives for R&D, 2014, as a percentage of GDP

This need is particularly clear in the case of tax incentives, as many young innovative firms typically make losses in the early years of R&D projects. Five G7 countries offer favourable tax incentives for R&D in SMEs vis-à-vis large enterprises (Figure 26) (OECD, 2017c)2. However, tax offsets are often only redeemable against corporate income taxes, and will not benefit young, innovative firms that do not generate sufficiently high profits at the early stages of their development to benefit from tax relief. France, Canada, the United Kingdom, Italy and the United States respond to this issue by providing refundable incentives for eligible small businesses in the case of insufficient tax liability. R&D tax incentives should be carefully designed to take into account the heterogeneity of potential R&D performers, and especially the position of young innovative firms. Another solution, that has been taken up by a number of governments is to move towards income-based tax incentives such as patent boxes

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2  The definition of SME, start-up or young firm for tax purposes varies across OECD countries and typically relates to firm characteristics such as employment, turnover, corporation and ownership status or firm age.
However, as well as suffering from deadweight losses and providing windfall gains to some firms, the benefits of such incentives are likely to accrue mainly to multinational incumbents, which are better positioned to find ways of using these provisions to shift profits across jurisdictions, rather than young, innovative firms (OECD, 2015g).

**Figure 26.** A large number of G7 economies offer favourable tax incentives for R&D to SMEs

Distribution of implied tax subsidy rates on R&D expenditures in 2016, 1-B-Index, by firm size and profit scenario

Governments also need to ensure that the patent system provides firms with the incentive to innovate. In certain sectors which make intensive use of knowledge based capital, with fragmented innovation processes, the patent system may unduly favour incumbents at the expense of young firms (Cockburn, McGarvie and Muller, 2009). Moreover, in sectors with higher firm entry and exit, stronger protection for patent holders may stifle diffusion to the extent that it is associated with larger productivity gaps between the most global frontier firms and the most productive firms nationally (Andrews, Criscuolo and Gal, 2015). Patent systems made need to be rethought to keep pace with these evolving dynamics. One key factor to ensure that patent regimes do not become a significant obstacle to entry and further technological development is the transparency of the patent system. Transparency also has additional positive effects when considering how it can facilitate the use of patents as collateral, giving young firms, with untapped resources in the form of IP a better chance of accessing finance.

Public support for innovation remains key to long term productivity growth. State-sponsored public research is vital a source of new know-how and technology in important areas like basic science, where the private sector is often not well equipped or motivated to invest. Firms tend to underinvest in so called ‘blue skies’ research and development (R&D) on account of its costs and uncertainty, the time required to obtain returns on investment, and the possibility that competitors can capture knowledge spillovers. Yet, many of today’s innovations would not have been possible without the scientific and technological developments enabled by public research. Much has been made of famous contemporary examples including Apple’s Siri (Mazzucato, 2011). Much of this research began life in universities and public research institutes (PRIs), which are predominantly funded by governments, and often undertake longer-term and higher-risk research. Although they account for less than 30% of total OECD R&D expenditure, universities and PRIs perform more than three-quarters of total basic research (OECD 2016o). They also undertake a considerable amount of applied research and experimental development that has more immediate potential for translation into tangible societal benefits. Yet, despite this expenditure on R&D by universities and PRIs in OECD countries began flattening out in 2010 following three decades of growth. One reason for this has been pressure on Government budgets, both in the wake of the financial crisis and due to longer term structural shifts like population aging. But another factor could be that rising
international connectedness and the key role of MNEs in driving frontier R&D imply that the benefits from public research and support to private R&D will become more widespread globally, weakening incentives for national governments to support these activities (Braconier et al., 2014). As a result, global mechanisms to fund and co-ordinate public investment in research are becoming increasingly desirable.

4.4 In an increasingly global context, efforts to promote business dynamism and reap the benefits for inclusive growth need to continue to strengthen the global tax infrastructure

Efforts to crackdown on international tax avoidance should be strengthened to help create a level playing field for firms and share the benefits of increased business dynamism. Reducing overall tax avoidance by companies and strengthening growth in an international context requires implementation of the recommendations of the OECD/G20 BEPS project and the International VAT/GST Guidelines. The introduction of AEOI as well as the continued development of Exchange of Information on Request (EOIR) also marks a step change in tax transparency for businesses and individuals (Figure 27), but there must be continued focus on the peer-review process and also the development of the network of exchange of information agreements for these new systems to maximise their effectiveness (Box 7).

Exchange of information should reduce the extent to which individuals are able to use offshore structures to avoid and evade tax. This reduced tax evasion and avoidance is expected to result in an increase in tax revenue from capital income. However, reduced avoidance and evasion opportunities strengthen the tax base and ensure the more effective taxation of capital income (see Chapter 2).

Figure 27. EOIR relationships have grown rapidly in the last 7 years

Bilateral Relationships and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAC)


Digitalisation and data offer new opportunities to increase tax compliance and reduce costs per tax dollar. Increased digitalisation and the spread of the cashless economy create new opportunities to improve tax compliance, reduce informality, and reduce compliance costs by allowing many transactions to be transmitted directly to tax authorities. Expanding such automatic collection provides opportunities to reduce tax exempt thresholds for SMEs without high compliance costs, while at the same time expanding the VAT base and increasing its efficiency (OECD, 2016q). Increased use of big data technology offers revenue authorities the opportunity to extract better administrative value out of existing data, by better managing and addressing tax risks from tax avoidance, evasion and fraud.
The Global Forum now has 139 members on an equal footing and is the premier international body for ensuring the implementation of exchange of information in the tax area. Exchange of information has been a key change in the international tax architecture in recent years with respect to the taxation of capital income. The Global Forum has pursued this work along two main lines; Exchange of Information on Request (EOIR) and Automatic Exchange of Information (AEOI).

EOIR has long been a component of tax treaties; however, it has greatly expanded through the increased use of the International Standard of Exchange of Information on Request (Global Forum on Transparency and Exchange of Information for Tax Purposes, 2016). There are currently almost 7000 EOIR relationships (see Figure 9).

Ninety-eight countries have committed to exchange information automatically. There are currently 1300 bilateral exchange relationships activated based on the OECD’s Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAC), bilateral information exchange agreements and EU directives on information exchange. This means that AEOI does not yet have the same coverage as EOIR, though this should change with time.

EOIR appears to have had an impact; initial statistical studies suggest that taxpayer information exchange agreements do reduce tax evasion through the use of offshore havens (Braun and Weichenrieder, 2015; Hanlon et al., 2015). However, studies also show that in response to the signing of agreements, taxpayers seeking to evade tax may shift income and assets to jurisdictions that are not participants to information sharing agreements (Johannesen and Zucman, 2014). Ensuring the comprehensiveness and density of the network of information sharing agreements will be an important part of enhancing the success of these efforts. As AEOI has only begun in 2017, no detailed statistical studies have been conducted on its impact, though countries already received close to 80 billion EUR in unplanned additional revenue as a result of voluntary disclosure programmes and other similar initiatives in the lead-up to the first exchanges (OECD, 2017b).

Source: http://www.oecd.org/tax/transparency/automaticexchangeofinformation.htm

The digital economy also poses challenges to tax collection through new business models and new data. OECD analysis suggests that businesses remit the vast majority of total taxes to OECD governments on behalf of themselves and others and therefore, that they are a crucial element of the tax collection process (Milanez, forthcoming). New business models in the digital economy will increase the number of taxpayers remitting to tax authorities, and also present challenges for the collection of VAT, presenting new tax compliance challenges that must be met with better digital strategies and increased international cooperation.

Strengthening the quality of tax policy requires improved analysis of the burden of taxes. Understanding which economic agents bear the economic burden of taxation is crucial for an effective distributional analysis of the system. Current approaches to taxation often assume that the true economic incidence of a tax is the same as a tax’s legal liability, though this is by no means the case (Kopczuk et al., 2016). For example, some studies estimate that approximately half of the corporate income tax burden is passed on to workers in the form of lower wages as opposed to falling on capital owners (Arulampalam et al., 2012). Tax policymakers need to understand better where the burden of their tax systems really fall to be able to design them effectively.

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Policy makers have a range of instruments and tools at hand to tackle rising inequalities, promote opportunities, and foster inclusive growth. Whatever the approach used, there are important policy synergies that can and should be exploited. There is no single best model or policy mix that works for all countries and each one will have to design its own strategy, depending on main sources of inequalities in opportunities and outcomes in different national contexts. There are, however, some common building blocks behind successful inclusive growth strategies, which could be reflected in the form of broad packages of policies aimed at either exploiting synergies by boosting growth and inclusiveness, or mitigating trade-offs while jointly addressing slow productivity growth and increased inequalities. This chapter describes these two approaches and identifies a series of lessons and best practices concerning the implementation of policies for inclusive growth, including the need for a whole-of-government approach.

5.1 Leveraging on synergistic instruments for growth and inclusiveness

There is significant scope among G7 countries for pursuing reforms that exploit synergies between growth and inclusiveness. At the current juncture where low sovereign interest rates provide more fiscal space, this includes a rethinking of the role of fiscal policy in accompanying structural reforms. G7 countries face common inclusiveness challenges that can be addressed with a relevant and country-specific package of policy measures in the following areas: i) promoting skills development and equity in access and quality of education; ii) reducing labour market insecurity and segmentation; iii) and closing the gender gap and facilitating women integration in economic activities.

5.1.1 Promoting skills development and equity in access and quality of education

Improving outcomes and equity in education and skills is fundamental to boost growth and make it more inclusive. Education shapes each individual’s life chances and is closely related to skills and training which in turn determines people’s ability to earn a decent living. Progress in this area can make growth more inclusive through by broadening the base for productivity growth and ensure it benefits wider parts of society. In this respect, education and training are key remedies to combat the twin challenge of slowing productivity growth and rising inequality faced by many OECD countries (OECD, 2016r; 2016s).

Enhancing equity in education and skills requires reforms in a broad range of policy areas, from preschool to university, as well as school-to-work transition, training and life-long learning. In this respect, investing in early childhood education and care has been shown to yield some of the largest returns. Returns from early intervention are particularly high for children from disadvantaged backgrounds, including children of migrants and refugees with language difficulties. Access to affordable childcare and pre-schools are thus strong instruments to ensure equity in compulsory education. In the area of higher education, tuition fees combined with financial support (i.e. mean-tested grants and income-contingent payback loans) for students from least well-off families are considered to achieve the best balance between growth and equity objectives.

While the potential returns from educational and skill reforms that address unequal access and quality are large, their effects are likely to take time to materialise. Raising the level of educational attainment
in the workforce takes time and higher social mobility takes at least a generation for the full effects to unfold. However, the case for emphasising education and skill reforms remains very strong. Reducing inequality in access to and quality of education is an important factor of \textit{ex ante} redistribution because it improves equality in market incomes. This may reduce the need and scope for governments’ \textit{ex post} redistribution.

5.1.2 Labour market insecurity and segmentation

Promoting job quality and reducing labour market segmentation, which disproportionately affect vulnerable socioeconomic groups, would boost growth by spurring workers’ reallocation, boosting productivity and enhance inclusiveness in the labour market. Compared to other socioeconomic groups, disadvantaged youth and the low-skilled are more likely to have lower quality jobs, including facing considerably higher labour market insecurity in addition to having the poorest performance in terms of employment and unemployment. This reflects to a large extent their overrepresentation among non-regular employees, facing higher risk of job loss, often poorer work environment and less social protection in the event of job loss. Moreover, evidence suggests large differences across G7 countries in the ability of non-regular contracts to be stepping stone into stable employment; France and Italy have some of the lowest transition probability of workers in temporary contracts into permanent contracts within three years. When these non-regular contracts do not provide opportunities to move to more stable jobs they contribute to rising inequalities.

In the pursuit of labour market inclusiveness, governments also need to enhance migrants’ integration in the labour market. Labour market integration is key to achieve migrants’ integration in society at large and would help reducing their high and rising poverty risks. In this respect, lowering barriers to “employability” is essential for migrants’ ability to get a regular job, which requires better recognition of skills acquired abroad and expansion of language courses; as well as ALMPs and coaching to address potential information hurdles beyond language barriers.

5.1.3 The gender gap and the integration of women in economic activities

Overcoming gender inequalities is fundamental to achieve inclusive growth, contributing not only to raise equity but also to improve efficiency. The social and equity arguments for enhancing the integration of women in the labour market and, more broadly, in economic activities, are strong and multiple, and can have long-lasting effects, as, for example, jobless families single parent (often mother) families are more likely to fall below the poverty line, and children living in such families may face a lifetime of disadvantage.

Improving the accessibility of child care service remains a priority to boost female employment. The affordable provision of early childhood education and care (ECEC) is key to enabling both parents to work in all G7 countries, and also to promote equality of educational opportunities for children from disadvantaged backgrounds. However, these issues do not disappear when children enter primary school, where more Out-of-School Hours (OSH) care services could play an important role in helping parents to work full-time. In view of the budgetary pressures, the often already existing school-facilities that could be used for longer hours and the relatively low investment requirements per child, limited public investment in this area could make as areal; change to working hours of parents.

One of the strongest measures to eliminate gender wage gap involves pay transparency. Companies are increasingly required to carry out analyses of gender wage gaps, and are requested (or required) to share this information with employees, auditors, or the public. For example in Germany, legislation expected to take effect in 2017 will require companies with over 500 employees to publish equal pay measures and
outcomes. The United Kingdom has taken a voluntary approach to asking companies to report differences in pay between male and female employees.

Certain G7 countries also need to pursue tax and transfer reforms to remove fiscal disincentives for women to participate in the labour market at their full potential. Reforms in this area would improve horizontal inclusiveness in the tax system, i.e. its neutrality towards taxpayers regardless of their gender (see also Chapter 2).

Governments have implemented a range of policies that attempt to address the inequalities associated with parenthood. Some countries like Germany and France provide incentives to fathers to take at least two months of parental leave. Since 2014, France effectively reserves at least 6 months of parental leave payments for fathers in addition to two weeks of paid paternity leave. However, at 15% of average gross earnings, the parental leave payment rate is low, and so is take-up among fathers. In Germany, in 2007 parental leave transfers became earnings-related payments for twelve months with another two months possible for the partner (typically the father) if s/he used at least two months of parental leave. Following reform, the proportion of children with a father that used parental leave increased dramatically—from 8.8% for children born in 2007 to 32% for all children born in 2013, and 2015-reform provides further financial incentives to fathers and mothers to better “share” working hours among partners in couple families.

5.2 Mitigating trade-offs while addressing the productivity and inequality nexus

There is a strong case for reform packages when it comes to addressing potential policy trade-offs between growth and inclusiveness objectives. Some reforms can have adverse effects on some individuals, often those that are already disadvantaged on the ground of skills income, or age. This raises significant political economy issues to the extent that losses from reforms can be concentrated and highly visible, as opposed to gains that are diffuse and often medium to long-term. In addition, the trade-offs between growth and inclusiveness are likely to persist and may even intensify in an increasingly globalised and digitalised world. These issues should be recognised and addressed upfront to overcome current and future challenges faced by G7 countries. This section discusses some of the key areas where trade-offs are likely to emerge and presents coherent reform packages to address them.

5.2.1 Addressing the twin challenges of slowing productivity and rising inequality

Confronted with the twin challenges of slowing productivity and rising inequality, policies should tackle the factors responsible for weak productivity growth. As highlighted in chapter 1, the increase in earnings inequality was associated with a rise of productivity dispersion across firms. Repairing the diffusion machine is important on two grounds at the very least. First, stronger productivity growth is important as in the long run productivity is the major source of living standards including among the lowest-income households. Second, stronger productivity growth is important for reducing market income inequality but also because in a context of low productivity growth, the scope for redistributing income through the tax and transfer system is lower. Productivity gains have been decelerating in a vast majority of countries, with the slowdown going back to around 2000, at least in advanced economies. The main factors behind the aggregate slowdown of productivity include the decline in the pace of investment in knowledge-based capital (KBC), the decline in the pace of business start-ups and the widening dispersion of productivity growth across firms within industries (see Box 8 and chapter 4). Policies addressing these factors typically consist of strengthened product market competition, to raise incentives to invest in KBC and innovation and reallocation of resources from low- to high-productivity firms.
Promoting a better diffusion of technology and know-how from frontier firms to lagging firms has the potential to both boost economy-wide productivity and reduce income inequality. However, this by no means implies that technology diffusion will automatically translate in declining wage dispersion. Empirical evidence shows that globalisation and especially digitalisation, which have the potential to facilitate technology diffusion, tend to strengthen the link between productivity and wage dispersion. The emerging question is then of how best to promote technology diffusion in a way that is conducive to lower wage dispersion in the context of a growing digitalised and globalised world. Promoting equality of educational opportunities and the adaptability of the workforce through life-long learning and requalification and fostering more competitive markets to level the playing field should help, though greater competition, by raising the returns to skills, may also increase inequality across qualification levels (e.g. Guadalupe, 2007, Fernandes et al., 2014). In a longer-term perspective, competition and innovation policies may also contribute to enhance equity, for instance if they allow for reducing firms’ rents and softening the market dominance of incumbents, while promoting social mobility. Indeed, recent evidence suggests that intergenerational income mobility increases with the degree of entrepreneurship and innovativeness in the economy (Aghion et al., 2015).

Box 8. Understanding the policy drivers of technology diffusion

Recent empirical analysis based on firm-level data has suggested that key factors shaping the effectiveness of knowledge and technology diffusion include cross-border trade and FDIs (global connections), investment in KBC and the efficiency of resource allocation across firms and industries:

- With some exceptions in specific sectors, barriers to foreign trade and investment are generally low across G7 countries even though obstacles remain through the differential treatment of foreign suppliers with respect to public procurement, taxes and subsidies or entry regulation as well as behind-the-border complications such as the absence of recognition of foreign regulation and opacity of domestic regulation.

- Encouraging domestic firms to adopt, and enabling them to adapt to new and advanced technology calls for policies that promote synergic investments in R&D, skills, organisational know-how (e.g. managerial quality) and other forms of KBC, such as big data. For instance, strengthening the collaboration between research centres and industry as well as improving the efficiency of public support for private R&D are policy objectives that can be shared by most G7 countries.

- The decline in business start-ups and turnover suggests that barriers to entry may have been creeping up (see also chapter 4). Different factors could be contributing, including a slower rate of exit (reducing capital and labour resources available for new firms), the rising dominance of global frontier firms and their capacity to fend-off potential entrants, and the unintended impact of policies in areas such as taxation and R&D support which often favour incumbents.

Source: http://www.oecd.org/global-forum-productivity/

5.2.2 Addressing displacement costs

Reforms to revive business dynamism by reducing resource misallocation and encouraging the downsizing or exit of inefficient firms may also entail distributional costs associated with displacement
effects. By raising competitive pressures, product market reforms, in particular in industries characterised by large incumbent firms such as in network industries (OECD, 2016r, Chapter 2), may result in strong restructuring of companies and large churn rate. Reforms to increase the efficiency of insolvency regimes and in a few cases also reforms that boost trade intensity, especially in advanced G7 economies, have the same effects by exposing workers to external competition (e.g. from low-wage countries).

Policy packages should be designed to minimise the costs of worker displacement by enhancing the re-employment prospects of displaced workers. Displacement effects associated with trade exposure are among the most salient and visible costs of globalisation in advanced G7 economies. In this regard, priority should be given to policies that offer a “springboard” to new jobs (Trebilcock, 2014), with a view to help people adjust faster during an economic downturn, reducing long-term unemployment spells and the resulting depreciation of skills and employability. Such policies put individuals back in control and help mitigate pre-redistribution income inequality, which reduces the need to resort to compensatory redistribution policies. Springboard policies require foremost effective active labour market policies and retraining support for jobseekers, especially when activation systems are geared around early interventions of the PES and when programmes are well targeted to specific participant groups. Such is particularly the case for older and tenured workers who are typically more exposed to displacement and for whom displacement costs (in terms of earnings losses after displacement) are typically higher (relative to youth and prime-aged). Well-designed requalification and training programmes are a key priority to limit displacement costs for such workers.

Moderately-generous unemployment benefits and social-assistance systems with a wide coverage are key for the effectiveness of active labour market policies. Unemployment and social-assistance benefits provide the principal instrument for linking jobless people to employment services and active labour market programs. By contrast, those outside the scope of benefits can find accessing these services significantly more difficult, insofar as they may lack a sufficient motivation for enrolling into programmes or simply lack the relevant information to self-assign themselves to the most appropriate activity (Immervoll, 2012; OECD, 2015h, Chapter 3). Jobseekers are referred to employment services, which provide job-search assistance or, depending on the unemployed person’s profile, direct them towards more intensive programmes, while their financial incentives of taking up gainful employment and/or actively follow the assigned programme increase, as potential sanctions significantly raise the cost of breaching the “mutual obligation” contract and losing benefit eligibility. This occurs when benefits are combined with effective monitoring and enforced sanction systems within a “mutual obligation” framework in which governments have the duty to provide jobseekers with benefits and effective services to enable them to find work and, in turn, beneficiaries have to take active steps to find work or improve their employability.

Countries that do not have efficient programmes in place should now prioritize (including by creating the needed fiscal space) the development of active labour market policies as a key pillar of their inclusive growth strategy. The effectiveness of ALMPs has been found to be stronger during a downturn (Bentolilla and Jansen 2016), but if efficient programmes are not already in place, there are limits to how rapidly ALMPs can be scaled-up as unemployment goes up, since the fine-tuning of these institutions typically takes several years (OECD 2016s, Chapter 3). At the same time, the quality of spending matters as opposed to just the sheer quantity of spending and again the provision of services in this area should be adapted to country-specific institutional settings. Indeed, the effectiveness of ALMPs has been found to be stronger in countries with more efficient public sectors (Andrews et al., 2016).
Activation and reskilling strategies require complementary policies for helping displaced workers finding good quality new jobs. These include:

- Structural reforms that stimulate labour demand to raise reemployment probability for workers displaced by business closure, as for instance reductions in labour tax wedges targeted at low-wage workers (who are more likely to be affected by business closure and industry restructuring) and of product market reforms that reduce entry barriers for new firms.

- Structural reforms that address policy-induced distortions in housing markets with a view to easing geographical mobility such as reducing stringent land-use regulations as well as rent controls; as well as reducing high transaction taxes on buying and selling property.

The possible trade-off between reallocation-enhancing job protection reforms and short-run employment and wage losses is small in the G7 countries characterised by significant labour market dualism. Reforms that lessen job protection may result in larger unemployment and lower wages in the short-run. However, designing those reforms with a view of making job protection even for labour market insiders and outsiders, will minimise such trade-offs. Moreover, empirical evidence and recent reform experiences in this area suggest that policy packages can be designed so as to limit any short-term losses resulting from the easing of labour market regulations:

- Effective ALMPs to provide job search assistance and re-employment support for workers in transition as well as to promote skills upgrading, matching and lifelong learning (see above).

- Product market reforms to reduce monopoly power and barriers to entry in industries characterised by large pent-up demand with a view to allow labour demand to rise and avoid workers to borne the cost of reform adjustment. In this respect, evidence suggests that over the recent period OECD countries have failed implementing coherent packages of labour and product market reforms, as reforms have been undertaken either in the labour market or product markets, but very rarely in both areas (OECD 2017b, Chapter 1). Better coordination of product and labour market reforms across different areas would ease implementation, maximise their impact in terms of growth, job-creation and equity at the same time.

- Collective bargaining reforms encouraging more flexibility in working conditions and wage setting so as to allow firms to make use of variables other than employment when adjusting to the required restructuring.

In the case of job protection reforms, there is also evidence the implementation of new regulations can be limited to new hires (grandfathering). Theoretical and empirical work shows that, in this case, reforms typically lead to a positive effect on hiring with no effect on separations (OECD, 2016b, Chapter 3).

Compensatory policies through income redistribution also have a role to play to cushion shocks, smooth adjustment and reduce post-redistribution inequality. Strong and well-designed social safety nets programmes are all the more needed in a context where: i) increased globalisation makes economies more vulnerable to external shocks and, ii) rising non-standard work excludes a higher proportion of the workforce from unemployment benefits. As a result, springboard policies should be articulated with social protection programmes with a broad coverage.

Reforms of public transfer schemes need to reflect the changing nature of work. Priority should be given to expanding access to unemployment benefits for workers in non-standard forms of employment, with
typically short work tenures relative to workers on permanent contracts: absent policy changes in this area, a rising share of non-standard workers implies that redistribution is becoming less effective at reducing unemployment-driven increases in inequality. In other words, adapting to structural changes in the labour market implies shifting protection from workers to individuals, while addressing the balance between ensuring income protection and maintaining work incentives. As discussed above, reaching a large coverage of unemployment benefits and social-assistance systems has also positive consequences on the effectiveness of ALMPs.

5.2.3 Addressing distributional concerns in tax design

Reforms that foster growth in the tax system that involve equity trade-offs should include compensatory measures to address distributional concerns. Trade-offs between efficiency and equity are relatively salient and well-known in the area of taxation. For instance, shifting taxation from taxes on income to taxes on consumption and property can have negative distributional consequences. Research shows that higher consumption taxes may increase inequality in the short run, although over the lifecycle the effect may be more neutral in terms of its distributional impacts (OECD, 2014a). These trade-offs can be mitigated through specific policy measures (Brys et. al., 2015). Policies following this approach include:

- **Using part of the revenue raised from broadening the base or increasing the standard rate to compensate low-income households.** This can be achieved by an income-tested tax credit or benefit payment targeted to lower income households, taking into account equity and efficiency considerations in setting the income–tested withdrawal rate. More broadly, cuts in direct taxes will meet inclusiveness objectives if targeted at low-income households and workers, whether this is achieved by lowering personal income taxation on low-wages or by introducing/ expanding in-work benefits or income tax credits schemes.

- **Broadening the VAT base by removing reduced VAT rates and exemptions that give a proportionately larger tax saving to those on higher incomes than to those on lower incomes.** These include such as reduced rates on restaurants, hotel accommodation, books and cultural activities such as theatre and cinema.

- **Increasing recurrent taxes on immovable property while minimising any adverse distributional effects.** This could include applying a tax allowance and a mildly progressive rate schedule based on owners’ income.

Reductions of personal income taxes can be achieved without negative distributional consequences by focusing reductions on those with low levels of income and by strengthening the taxation of capital income. Such policies can have synergies for growth and inclusiveness:

- **Targeting tax reductions towards those on low wages by introducing or expanding in-work benefits or earned income tax credits.** Existing research provides strong support of in-work benefits or tax credits as a means of achieving efficiency and equity in taxation systems, they need to be carefully designed to avoid poverty traps (Immervoll and Pearson, 2009). They should also be combined with other policies to encourage labour market integration.

- **Targeting tax reductions towards second earners can improve horizontal equity in the tax system and address gender gaps in labour market participation:** i) by moving away from family-based taxation towards individual-based taxation and towards the provision of anti-poverty measures
such as credits and benefits at the individual level, ii) by providing targeted childcare support such as targeted refundable tax credits for children.

- Reducing labour costs at low income levels by reducing social security contribution rates, and by broadening the base on which social security contributions are raised in cases when the contribution-benefit link is not strong such as health insurance and family allowances. Financing social security through progressive income taxes or taxes on consumption and property could help reduce labour costs at low-income levels and increase employment while also ensuring the sustainable financing of social security systems.

- Reduced income taxation for those on lower incomes can be partially financed by eliminating the tax breaks that disproportionately benefit the more affluent households, such as those provided for mortgage interest, retirement savings, or inheritances.

Efforts to reduce tax avoidance and evasion are needed to achieve greater equity in addition to improved efficiency. Progress in fighting tax avoidance and evasion may reduce the ability of high-income earners to respond to taxation by shifting income and profits and thus make progressive taxation more effective. Reducing tax avoidance and evasion will also enhance compliant taxpayers’ perception of the tax system as fair. Reinforcing the efficiency of measures against tax avoidance and evasion will require national and global efforts: improvements in tax administration as well as stronger international cooperation at the G7 and global level. International efforts need to be continued to create fairer and environmentally sustainable global rules, including continued implementation of the recommendations of the OECD/G20 BEPS project as well as the strengthening of the exchange of information through the work of the Global Forum on Transparency and Exchange of Information for Tax Purposes.

5.3 A whole-of-government approach

Increasing complexity and citizen demands, combined with growth in new technologies and the need to meet cross cutting global commitments, will require the public sector to work in new ways to promote inclusive growth and restore trust in governments. Many OECD countries are deploying governance frameworks to support a more inclusive growth agenda across the policy cycle and promote trust in government (OECD 2016t). This includes giving citizens a voice in the design and implementation of public policies, including service delivery and ensuring accountability through policy evaluation. Despite some encouraging initiatives, a lot more needs to be done to coordinate efforts across government and between levels of government. In addition, while countries have increased the evidence-base for policy-making and use key national indicators to guide priority setting and policy design, more information is needed on the distributional impacts of policies across different social groups and places.

While the specific design of such mechanisms will depend on country specific characteristics, some broad lessons and associated institutional requirements for implementing an Inclusive Growth agenda emerge. For example, a number of policy instruments are available to align inclusive growth objectives with resource allocation over time. These include medium-term expenditure frameworks and performance-related budgeting as well as evaluative tools such as budget and regulatory impact assessments and expenditure appraisals for both current and capital spending. Regulatory Impact Assessments (RIA) aim to provide information on the distributional impacts of regulation which can help reveal and monitor trade-offs between the economic, social and environmental effects of regulatory responses. Evidence shows that some OECD countries are using RIA for this purpose (Figure 28). Spain for instance requires impact assessments on gender and regional distribution and encourages social impact assessments including on equal opportunity and non-distribution. Behavioural insights have also been
increasingly embedded in organisational decision-making across government bodies (OECD forthcoming f) with the purpose of informing design of policies that are particularly relevant from an Inclusive Growth perspective.

**Figure 28.** Types of impacts integrated into regulatory impact assessments

Note: Based on data from 34 countries and the European Commission.


**Co-ordinated action is necessary across policy silos to achieve cross-cutting objectives like inclusive growth.** The number of cross-ministerial policy initiatives has significantly increased since 2008 in OECD countries (OECD 2014d) and with it the need to adopt capacities to forecast future scenarios and ensure leadership is focused on mobilising a broad range of actors. Adopting such systems approaches will help governments confront problems that span administrative and territorial boundaries (OECD forthcoming f). The centre of government can play a strong convening and steering role in ensuring that these new management tools and practices support the inclusive growth agenda.
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