Policy Debate: How to Make Growth More Inclusive?

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Introduction

Let me begin with an awkward confession. I am a macroeconomist. Macroeconomics is difficult but, as you are aware from reading the news, we have done a splendid job regardless. In contrast, I always thought microeconomics and recipes for structural reform were inherently easier. However, after two years of chairing the Economic and Development Review Committee, which does country reviews at the OECD, I have begun to realize that this is not so. This conference on "Promoting Inclusive Growth " (not **just** growth, but inclusive growth) has confirmed my earlier misgivings. Unfortunately, my overwhelming impression from yesterday's discussion was that achieving growth with inclusion is going to be very difficult. There are number of reasons to believe this. Fortunately some of the discussion today has left me with a much more positive impression. Let me say a few words both about yesterday's discussion and what we heard earlier this morning. To cut to the bottom line, I am now "still pessimistic but more hopeful".

Some reasons to be pessimistic

First, as Tom Peters, the management consultant, once said "If you don't know where you're going, you're going to wind up somewhere else". Yesterday, I heard at least six different definitions of what we are trying to achieve. Variously, "inclusiveness" was said to mean

- More equal income distribution
- A reduction in absolute poverty
- The need to internalize externalities in measuring growth
- Lowering the North-South income gap
- More equal opportunities, especially access to services such as education, finance, the judicial system etc.
- Including Emerging Market Economies (EME's) in the governance of IFI's

Moreover, no one even mentioned the issue of the rural-urban divide and regional divisions in many countries. This absence of clarity about objectives is not helpful for policy makers.

Second, some of what we are trying to achieve has both an objective and subjective component. For example, what **is** happening to inequality is different from what people **believe** is happening to inequality. Think of Brazil where the Gini Coefficient is declining, but where public opinion surveys indicate there is a general perception that inequality is increasing. Moreover, achievement of absolute advances in inclusiveness can still lead to explosive results if even a “kernel” of unfairness remains. Think of Tunisia, where absolute advances in inclusiveness have been very great, but where the still privileged position of the President’s family led to an outright revolution.

Since even a three year-old will tell you "it's not fair, this mental notion of "fairness" seems hardwired into our brains, The Canadian author Margaret Atwood has recently written a book about debt (a remarkable work called “Payback") in which she contends that the whole infrastructure of both finance and justice rests on this fundamental psychological concept. From a policy perspective, however, this reality creates difficulties in that it is hard to assess how much inclusiveness is either necessary or desirable.

Third, with respect to some elements of inclusiveness, history seems to be going in the wrong direction almost everywhere. In recent decades, income inequality in most Advanced Market Economies (AME’s) has increased sharply- no more so than in the United States and the United Kingdom. Excessive bankers’ pay has been a particularly egregious outcome, but even after the crisis we have not managed to do much about it. In other AME’s (Germany and Japan for example) similar trends, albeit more moderate, have also emerged. With the exception of Brazil, existing inequalities in the larger EMEs are either stable at high rates (Mexico) or rising sharply (as in China, India and Russia). In contrast, there has been a sharp reduction in absolute poverty in many countries in recent years. Nevertheless, the crisis experience of 2008 to 2009 indicates that even these advances might be more fragile than many think.

Fourth, when one considers the various sets of structural reforms, discussed in the successive sessions of this conference, a number of them seem as likely to make life harder for the poor and unskilled as likely to make life easier. For example

- Innovation could lead to (short-term) increases in productivity with the unskilled being hardest hit
- Green growth must begin with cuts to energy subsidies. Virtually all of the poor will be affected by this, even if the largest proportion of such subsidies goes to the rich.
- Financial deepening, if badly done, can hurt the poor as well as help them. Think of the recent subprime experience in the United States.

- Fiscal restraint does seem to hurt growth, at least in the short run. Moreover, as indicated by recent work at the IMF, the poor ("outsiders" in the work place, often without permanent contracts) tend to be the first ones to be laid off in a downturn

Fifth, the political economy of inclusiveness is not going to be easy to apply. We learned yesterday that the power/political structure is highly informal in EME's (reflecting the importance of the informal economy), and its primary purpose is to divide up pure rents and quasi-rents amongst the ruling elite. It was suggested that in such economies, you actually need a very significant increase in output and incomes, before there would be enough left over to "trickle down" to the poor. I would add, moreover, that the power/political structures in some AME's seem to share some of these characteristics as well. This morning it was also noted that "entitlements" in AME's are absorbing more and more of government resources. As a result, the fiscal room for discretionary manoeuvre to help the poor is, in many countries, getting more and more constrained.

Sixth, even success stories, like Brazil, pose difficulties. Yesterday, we heard that the falling Gini Coefficient in Brazil is due to some combination of higher employment rates, a drop in fertility, increases in school enrolment, less discrimination in labour markets, and cash transfers (Bolsa Familia). The problem, however, is that all of these suggested causes are interdependent. For example: more education leads to more employment; more employment and education leads to lower fertility; lower fertility allows more women to work and better education for fewer children. So the bottom line is that we are not even sure what has been crucial to the Brazilian outcome. Given this uncertainty, can we then be sure about the lessons to be drawn for others?

Some reasons to be optimistic

In this morning's discussion, some points emerged that might help dispel the pessimism. In particular, we were reminded that, although analytical uncertainties remain, we do seem to have learned something about what works to increase growth and inclusive growth, and what doesn't. The challenge now is to identify programs that seem to have been successful somewhere, and then try to introduce them elsewhere. With time, such experiments will make clear whether the apparent secret of success has in fact been identified, and if it can also work in different cultures.

A number of such programs were identified. In education, Finland is consistently one of the highest achieving countries in PISA scores. This is due in large part to the special attention paid to those students in the lowest quintile of achievers. Raising their standard both raises the average score and substantially reduces its dispersion. In labor market reforms, the Danish example of "active flexicurity" also seem worth replicating. This involves reducing job security (especially employment protection legislation) for permanent employees, providing better support for the unemployed, and actively helping people find work through training and placement.This was referred to by one participant as a combination of "state intervention" and "radical individualism".

There was also a sense in the meeting that conditional cash transfers (conditional on children going to school or attending health clinics) seem to have significant promise and at a relatively low cost as a proportion of GDP. Moreover, advances in technology are making it Increasingly possible to monitor the "conditionality "aspect of these programs. Finally, it is clear that many countries would derive significant economic benefits from removing impediments to women and young people working, and to implementing measures to keep older workers in the workforce. Note that all of the reforms suggested just above (education, labour markets, etc.) would raise both growth and inclusivity.

A second piece of good news is that even macro economists are now starting to focus on issues of distribution and inclusion. One reason for this is the hypothesis that the current crisis (in the United States at least) has its roots in distributional issues. One is reminded of the old joke that "Even an economist, when he sees something happen, will admit that it is possible".

The argument behind this hypothesis is that globalization (via factor price equalisation) and technological progress have primarily hurt the unskilled and the uneducated. In particular, jobs in manufacturing have been under serious threat. Instead of adjusting to this reality, the United States and others tried to paper over the problem using credit expansion. Poor people were thus able to "keep up with the Joneses" by borrowing in order to consume. This tendency was encouraged by low policy rates, financial innovation and by the implicit subsidies provided by Fanny Mae, Freddie Mac and other government sponsored enterprises. Unfortunately, the associated buildup of household debt meant this "fix" was temporary rather than permanent. Thus, when the market began to suspect that some loans would never be repaid, the crisis erupted. Sadly, it may not be over yet.

Conclusion

The EDRC process of country review at the OECD has, in recent years, put a lot of emphasis on structural changes to promote growth. Inclusiveness and distributional issues have thus far been treated as matters of only secondary importance. Going forward, these issues should now be given higher priority. This conclusion reflects, not only insights from this valuable conference, but also the recognition that inclusiveness and distributional issues can have significant implications for both longer term growth and macroeconomic stability.