



All on Board

MAKING INCLUSIVE GROWTH HAPPEN



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Foreword

This report could not have come at a more crucial moment. A hesitant recovery from the financial and economic crisis, widening income gaps between rich and poor, and high unemployment in the mature economies have raised awareness about the need to restore growth and at the same time make sure that the dividends of greater prosperity are shared more evenly across society. In many emerging-market economies and developing countries, robust growth and the increased affluence that comes with it often have not delivered inclusive prosperity, economic opportunity, and better social indicators for all.

It is important to make clear that when we talk about inequality, we must talk about more than income. Employment prospects, job quality, health outcomes, education, and opportunities to build wealth over time matter for people's well-being and are heavily determined by their socio-economic status. Those who are shut out of opportunity often live shorter lives and find it difficult to break away from a vicious confluence of poor educational opportunities, low skills and limited employment prospects. They also are far more likely to be exposed to environmental hazards and violence, both of which can impair brain functioning in powerful, long-lasting ways, making it harder to succeed. The result is an uneven economic patchwork, where regions within countries and neighbourhoods within cities prosper while others fall farther behind. Moreover, there is growing evidence that inequality is harmful to everyone in society and that greater social and economic inclusion is strongly associated with longer and stronger periods of sustained economic growth.

Against this background the OECD and the Ford Foundation have joined forces to contribute to the policy debate about Inclusive Growth. The OECD's work on well-being (How is Life?), income inequality (Growing Unequal? and Divided we Stand), structural policy reform (Going for Growth), development (Perspectives on Global Development: Social Cohesion in a Shifting World) and institutions (Governance at a Glance) all provide a solid foundation for understanding the relationship between growth and inclusiveness.

All on Board: Making Inclusive Growth Happen takes a comprehensive approach to examining growth, looking beyond traditional monetary indicators to dimensions that reflect the quality of life of all participants in an economy. Indeed, the report begins by detailing the various dimensions of inequality that affect people's well-being. It goes on to formalise the notion of multidimensional living standards in an analytical tool based on the OECD Framework for Inclusive Growth that allows policy makers to measure growth in ways that incorporate these important factors that affect people's lives and well-being.

The report goes on to discuss win-win policies that can 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. One clear-cut lesson from the report is that investing in the education and skills of people at the bottom of the distribution will pay long-term dividends for the economy and enhance individual well-being. Moreover, complementing structural policies with place-based approaches to tackling inequalities will help advance both

equity and growth objectives on the ground in cities and metropolitan regions. It is our hope that the report will provide a foundation for further exploration of circumstances where inclusion enhances economic growth.

The political economy of Inclusive Growth also features prominently in the report. Socio-economic inequalities often carry over to the policy making and political arenas. It is therefore important to ensure that all social groups have a voice in the policy making process, to help shape policies that reflect their realities and aspirations and those of the communities they represent. Pursuing decentralisation, developing new forms of collaborative and participatory governance, and exploiting new technologies with open data and transparency can help governments actively engage with stakeholders and foster more inclusive policy design and implementation.

Our hope is that the analysis and the policy lessons contained in this report will help change the conversation on growth and find practical application in the policies adopted by governments around the world. Together they are a first step towards building a new approach to economic growth, one that encompasses the many different factors that shape the lives of real people. The OECD and the Ford Foundation will continue to work to promote better policies and their effective implementation to achieve Inclusive Growth.



Angel Gurría
OECD Secretary-General



Darren Walker
President of the Ford Foundation

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This report contributes to the OECD initiative on “New Approaches to Economic Challenges” (NAEC), which was launched in 2012 at the OECD Ministerial Council Meeting (MCM), against the backdrop of slow growth, rising inequalities and high unemployment in many countries around the world. NAEC seeks to foster continuous improvement of the organisation’s analytical frameworks and advice, and it was also intended to contribute to the broader OECD effort to build an inclusive and sustainable agenda for growth and well-being. The *Inclusive Growth Initiative* (www.oecd.org/inclusive-growth) is a multi-disciplinary project which aims to identify and better understand policies that can 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).

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Given the cross-thematic nature of Inclusive Growth, this report draws on contributions from a large number of OECD Directorates. The main contributors were Paul Schreyer, Romina Boarani, Marco Mira D’Ercole, Fabrice Murtin (*Statistics Directorate*); Alain de Serres, Nicolas Ruiz, Orsetta Causa (*Economics Department*); Mark Pearson, Willem Adema, Michel Förster, Alessandro Goglio, Alexander Hijzen, Maxim Ladaïque, Gaetan Lafortune, Horacio Levy, Ana Noza Llana, Anne Saint-Martin (*Directorate for Employment, Labour and Social Affairs*); Dirk Van Damme (*Directorate for Education and Skills*); Jonathan Potter, Francesca Froy, David Halabisky (*Centre for Entrepreneurship, SMEs and Local Development*); Pierre Poret, Serdar Celik, Michael Chapman, Flore-Anne Messy, Gert Wehinger (*Directorate for Financial and Enterprise Affairs*); David Khoudour, Alexandre Kolev, Francesca Francavilla (*Development Centre*); Kumi Kitamuri and Ziga Zarnic (*Environment Directorate*); Serge Tomasi and William Hynes (*Development Co-operation Directorate*); Dominique Guellec and Caroline Paunov (*Directorate for Science, Technology and Innovation*); Raed Safadi and Przemslaw Kowalski (*Trade and Agriculture Directorate*); Mario Marcel, Christiane Arndt, Monica Brezzi, Paloma

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Executive summary

Inclusive Growth is about identifying policies that can deliver improvements in the population's living standards with a more even sharing of the benefits of increased prosperity among social groups. In a context of widening worldwide inequalities – in the distribution of income and social outcomes that matter for people's well-being – policy makers in advanced and emerging market economies, alongside their counterparts in developing countries, are examining the potential of Inclusive Growth policies to kick-start growth by turning equity into a driver of economic performance.

The many dimensions of inequality

The distribution of disposable incomes (after taxes and social benefits) has been widening in most OECD countries over the past 30 years, even in those countries which are traditionally more egalitarian. Today, the average income of the richest 10% in the OECD is around 9.5 times that of the poorest 10%, up from 7 times 25 years ago. Income gaps between rich and poor are much wider in developing countries and emerging-market economies.

In many OECD countries, rising incomes have disproportionately benefited the rich. In 2010, the richest 1% earned at least 10% of total national pre-tax incomes in 9 out of the 18 OECD countries for which data were available, with the figure at around 20% in the United States. This situation is in stark contrast to the prevailing picture in 1980, where the pre-tax income of the top 1% in the same countries failed to exceed 8%.

Absolute poverty has fallen worldwide, but relative poverty has risen in many OECD countries and many emerging-market economies. At present, 11% of the OECD population lives in relative poverty, with rates significantly higher in a number of the less affluent OECD countries and the United States. The number of people outside the OECD living in absolute poverty, on less than USD 1.25 per day, has halved since 1990 to an estimated 700 million. But this is still an absolute poverty rate of 14%.

Rising income inequality is often accompanied by greater polarisation in educational and health outcomes, perpetuating a vicious circle of exclusion and inequality. Moreover, growing unequally bears a cost on future economic growth, particularly where inequality of opportunity locks in privilege and exclusion, undermining intergenerational social mobility.

Towards a multidimensional framework for Inclusive Growth

Accounting for the multidimensional nature of inequalities calls for broadening the focus of policy analysis beyond income, by evaluating the effects of policies on both income and non-income outcomes, as well as for different social groups, such as the middle class and low-income households.

OECD analysis shows that “multidimensional living standards” – a measure that combines changes in household income, health and labour market outcomes – rose faster for more affluent social groups than for the middle class (the “median” household) or low-income households (those in the lowest decile of the distribution) on average among OECD countries. This suggests that improvements in the population’s longevity and strong job creation during 1995-2007 have not compensated for widening income inequality in OECD countries.

A better understanding of the effects of individual policies on specific social groups allows policy makers to identify trade-offs and complementarities between growth and distributional objectives, as well as taking corrective action, if needed.

OECD analysis shows for instance that reforms to reduce regulatory barriers to domestic competition, trade and inward foreign direct investment can lift the incomes of the lower-middle class by more than they do GDP per capita. Conversely, a tightening of unemployment benefits for the long-term unemployed, if implemented without a strengthening of job-search support and other activation programmes, may lead to a decline in the income of the lower-middle class, even if it boosts average incomes.

Identifying policies levers for Inclusive Growth

Tax and benefit systems have a profound effect on the distribution of income and non-income outcomes but are increasingly facing a trade-offs between affordability and effectiveness. More progressive tax schedules and better targeted social protection are effective drivers of equity. But there is much to do to improve workers’ employability through policies to strengthen activation and skills, which are pro-growth and inclusiveness-friendly.

Pro-competition reform in product markets can do much for growth and inclusiveness, promoting value for poorer consumers. However, it can also create short-term losers, as workers in previously protected industries are subjected to market forces. Governments can smooth the transition towards more competitive environments by implementing labour market intervention to help affected groups.

Policies can tackle unemployment and in-work poverty without hampering labour market efficiency. Reductions in the level of protection of permanent jobs can reduce labour market duality, making it easier for vulnerable and less experienced workers to find jobs. Enabling the workforce to upgrade their skills whilst promoting job quality and the employability of youth and the low-skilled through effective employment counselling, job-search assistance, and temporary hiring subsidies, can increase equity and pay long-term dividends for economies.

A broad range of actions can make education policy more growth-friendly and inclusive, including: increasing pre-school enrolment among economically and socially deprived households; managing school choice to avoid socio-economic segregation; and improving low-performing schools and classrooms by offering a quality learning experience for the most disadvantaged, giving them skills relevant to their local job market.

Structural transformation strategies in developing countries must target job creation and poverty alleviation. Aid policies can catalyse improved social conditions by supporting health care, education, and poverty alleviation programmes, while also accelerating structural transformation by financing infrastructure investment, building government capacities, and improving the business environment.

Inequalities and the problems to which they give rise have a spatial dimension. Better transport and housing infrastructure can spur growth and improve inclusiveness in cities, providing vital access assets for economically deprived areas to high-quality jobs and education.

Making Inclusive Growth happen: The role of institutions

Political and economic disparities tend to reinforce each other. Across the OECD, electoral turnouts are falling, and socio-economic disparities exist: adults with a tertiary education degree have a general election turnout 12% higher than those with secondary education or less, and older adults are more likely to vote than younger citizens.

For Inclusive Growth to work well, appropriate institutions are needed, and citizens must feel that they can trust them. New technologies can play an important role in strengthening inclusiveness in policy making and implementation, by enabling new forms of collaborative and participatory governance. Inclusive policy making and service delivery requires an effective decentralisation of policies which allows for better targeted place-based approaches.

An inclusive policy process should be inclusive across the policy cycle, requiring effective and representative citizen participation and mechanisms to curb the undue influence of money and power.

Chapter 1

Overview

What is Inclusive Growth? How can policies be designed and implemented to address rising inequalities and spur stronger economic performance? This chapter responds by providing an overview of the analysis and policy recommendations developed throughout the remainder of the report. In particular, the chapter illustrates the case for Inclusive Growth, reviewing trends of widening inequalities, and recognising that economic growth is not an end in itself, but a means to promote societal well-being. This leads to an outline of the OECD's approach to Inclusive Growth, premised on the importance of addressing multidimensional inequalities, and on recognising that they impact different groups in different ways. The implications for policy design are then examined, engendering the central insight that all economic and social policy choices should have the twin objective of promoting equity and enhancing growth. The ramifications for policy implementation are also considered, with emphasis placed on the importance of appropriate governing institutions and stakeholder participation.

Inclusive Growth, which is a new approach to economic growth that aims to improve living standards and share the benefits of increased prosperity more evenly across social groups, has become a major challenge for many countries around the world. This objective is particularly relevant in high-income countries and emerging market economies, where income inequality has reached levels unprecedented in the post-war period. Inequalities in other non-income outcomes, including educational attainment, health conditions and employment opportunities, have become important determinants of growth and well-being. Inequality of income and opportunity undermines growth prospects in the long term. Addressing the multidimensional nature of inequality and its impacts on different segments of the population matters for sustainable economic growth. Therefore, fostering Inclusive Growth is an important part of a pro-growth agenda.

1.1. Economic growth is not an end in itself; addressing the multidimensional nature of inequalities and their impacts on different population groups matters for Inclusive Growth

Conventionally, pro-growth policy analysis and advice have focused on options for improving the population's income and consumption possibilities. Economic growth – rising per capita output of material goods and services – has the potential to make all citizens better off materially, and to generate resources that can be used to achieve social goals and ensure that growth is maintained over the long term. Policy makers seek to improve the performance and long-term growth potential of economies, taking into account country-specific needs and circumstances, including their level of development and institutional capacities. Because progress is measured essentially at the level of an “average” individual, emphasis is placed on supply-side instruments, or policy actions that lead to increases in per capita output of goods and services over the longer term.

There is much to gain from going beyond income to include non-monetary dimensions that matter for well-being, and from assessing the impact of policies on different social groups. Employment prospects, job satisfaction, health outcomes and educational opportunities matter for people's well-being and are heavily conditioned by their socio-economic status. The most disadvantaged often live shorter lives and find it difficult to break away from a vicious circle of educational underachievement, low skills and poor employment prospects. Vulnerable social groups are also affected disproportionately by pollution and are often ill-equipped to cope with environmental degradation. Within countries, some regions, and even neighbourhoods within cities, prosper while others lag behind. As highlighted in OECD work, it is important to inform the policy debate about pro-growth policies with a better understanding of the drivers of both monetary and non-monetary outcomes, and actions that create opportunity for all segments of the population. The *OECD Framework for Inclusive Growth* contributes to this objective. It offers policy makers an analytical tool which provides a measurement of the different types of outcomes for different social groups and helps identify the synergies, trade-offs and unintended

consequences of policy actions, on the basis of a richer and broader panoply of policy indicators, and considers their impacts on different social groups, such as households with average, median or low incomes.

1.2. Recognition of the importance of Inclusive Growth comes against a background of widening inequalities

The distribution of disposable incomes (after taxes and social benefits) has been rising in most OECD countries over the past 30 years, including in countries where incomes were previously comparatively evenly distributed. The average income of the richest 10% is now about 9.5 times that of the poorest 10% on average in OECD countries, up from 7 times 25 years ago. In Germany, Norway and Sweden, the gap between rich and poor has expanded from less than 5 to 1 in the 1980s, to more than 6 to 1 today. The gap between rich and poor has risen even faster since the global financial crisis than it did in the previous decade. This contrasts with the post-war period of fast economic growth until the 1970s, when income distribution tended to become more equal in those OECD countries for which reliable estimates can be made.

In many countries, rising incomes have disproportionately benefited the rich. In 1980, in no OECD country did the richest 1% of the population enjoy more than 8% of total pre-tax incomes; by 2010, they enjoyed 10% or more in 9 of the 18 countries for which data exist, and as much as 20% in the United States. The global financial crisis and its aftermath put a halt to this trend, but preliminary evidence for some countries shows that this was only temporary and that the top income earners seem to have again reaped most of the recovery's benefits. The proximate cause of rising inequality is income from work: the ratio of the earnings of the highest paid to those of the median-income employee has risen substantially since the 1980s. Income from capital – dividends, interest and capital gains – is also unequally distributed, with those with the highest overall incomes receiving the most.

In developing countries and emerging market economies, income gaps between rich and poor are much wider than in OECD countries. Income inequality is narrowing in some countries, albeit from very high levels. This is the case in Mexico and Chile; but the ratio between the richest 10% and poorest 10% still stands at approximately 27:1 in these countries. Brazil considerably reduced the rich-poor income gap but it is still 50:1, and in South Africa, inequality has continued to rise and now it is over 100:1. As in OECD countries, it is inequality of market incomes that drives the distribution, exacerbated by large informal labour markets where earnings are typically low, and tax-benefit systems that are much less redistributive than in most OECD countries.

Absolute poverty has fallen worldwide, but relative poverty is on the rise in OECD countries and in many emerging market economies. Along with rising income inequality, relative poverty, measured by the share of individuals with incomes less than half of the national median level, has also been on the rise since the mid-1990s in several OECD countries. At present, 11% of the OECD population lives in relative poverty, with rates significantly higher in the poorer OECD countries and also in the United States. Elderly widows, children and youth are the most affected. By contrast, the number of people outside the OECD area living in absolute poverty, on less than USD 1.25 per day, has fallen dramatically, by more than half since 1990 to an estimated 700 million. But this still represents an absolute poverty rate of 14%, which is far higher in several developing countries.

Inequality goes beyond income and affects opportunities, like access to jobs. Seven years after the beginning of the crisis, about 8% of the OECD labour force is still unemployed, some 2.2 percentage points higher than at its onset. Youth unemployment is double the average of the OECD, and as high as 50% in Greece and Spain. Stable, well-paid, full-time jobs were the norm in the post-war decades of sustained growth in OECD countries, but this is no longer the case. The burden of labour market adjustment increasingly falls on non-standard jobs with low protection and low pay. Non-standard work arrangements make up 33% of total employment in the OECD. In addition, not all jobs provide a sure exit route from poverty: 8% of the workforce in OECD countries lives below the poverty line. Typically, unemployment or low quality jobs affect certain socio-demographic groups, such as women, immigrants and youth. Youth are particularly likely to hold temporary jobs, which offer limited job security, and no or little on-the-job training, with the risk of being trapped in a sequence of temporary jobs interspersed with spells of unemployment.

Rising income inequality is also accompanied by greater polarisation in educational and health outcomes, perpetuating a vicious circle of exclusion and inequality. There is indeed a strong link between an individual's educational attainment, employability and health status. In general, the low-skilled are far more likely to be unemployed than workers with higher education, especially if they are older. In all OECD countries except Mexico and Chile, adults aged 25-64 with tertiary education have lower unemployment rates than those with at most upper-secondary education, who in turn have lower unemployment rates than those with less than secondary education. Tertiary-educated adults are more likely than others to be in the labour force in the first place, and to earn higher salaries, enjoy good health and live longer. Poorer students struggle to compete with their wealthier classmates and go on to lower levels of educational attainment, lower salaries and shorter lives. Data from 14 OECD countries show for instance that on average people with better education live 6 years longer than their poorly educated peers.

The demographics of developing countries and emerging market economies lead to very large numbers of youth entering the labour market each year, and many do not find jobs in the formal sector. The youth then swell the numbers of those in the informal sector, who have limited or no access to unemployment insurance, health care or other social benefits. They also have essentially no access to further education and training, diminishing their chances of ever having a job in the formal sector. Meanwhile, in many countries, the skills advantage is less clear: young adults with tertiary education are more likely to be unemployed than those with only secondary education, perhaps because too few have studied in-demand disciplines like ICT and engineering.

Inequality of opportunity is detrimental to growth and well-being and requires paying attention to distributional effects of policies on different social groups. As long as all citizens have equal access to high-quality education, other public goods and services, finance and entrepreneurship, some level of inequality of outcomes is both economically inevitable and politically acceptable. However, inequality of opportunity can be particularly damaging when it locks in privilege and exclusion, which undermines intergenerational social mobility. Inequality is particularly likely to undermine growth if the income of the lower and middle-classes fall behind the rest – as it has in several OECD countries. Policies that aim to address inequality of outcomes will fail unless they ensure more equal access to opportunity in the form of high-quality education, health care and infrastructure, which remain unevenly spread both socially and geographically. This requires assessing the

impact of policies on heterogeneous population groups, and calls for measures that go beyond the “average” individual or household when gauging the success of pro-growth policies.

1.3. Taking account of income and non-income dimensions in the design of policies for Inclusive Growth calls for new policy tools

The notion of multidimensional living standards is particularly useful. It is an analytical tool based on the *OECD Framework for Inclusive Growth* that allows policy makers to gauge developments in income and non-income outcomes for different social groups and over specific time periods. The approach provides a measure of multidimensional living standards which accounts for selected non-income dimensions of well-being and their distributional aspects. It proposes risk of unemployment and health status as the non-income dimensions to be considered along with household income for the computation of multidimensional living standards. Thus, inclusiveness is captured by relating to three (income, jobs, health), rather than just one, dimensions of well-being. The proposed approach could be generalised to include additional dimensions (e.g. education, environment) or to focus on broader set of social groups to better capture the notion of Inclusive Growth in a larger group of low and middle-income countries.

An illustrative exercise carried out for OECD countries during the pre- and post-crisis periods shows that growth in multidimensional living standards varies among social groups. On the basis of the three selected dimensions (income, jobs and health), it appears that multidimensional living standards rose faster than GDP per capita before the crisis (1995-2007) for the average household than for those with incomes close to the median or at the lowest decile of the distribution (3.9% per year in average vs. 2.3%). Also, over the decade running up to the crisis, multidimensional living standards rose faster than GDP per capita, essentially due to rising household incomes and falling unemployment as a result of robust GDP growth, but also owing to improvements in health conditions, which have been associated with rising longevity. Moreover, comparison of patterns in multidimensional living standards shows that those countries that had the sharpest increases in joblessness during the crisis have also had the largest drops in multidimensional living standards.

1.4. Broadly defined economic and social policy choices should be made in the context of what they can do to foster both equity and growth objectives

Sound macro-economic policies are a pre-condition for sustained growth, employment and poverty alleviation, but they can also generate some trade-offs between equity and efficiency. A stable and predictable macroeconomic framework helps households and firms to make better decisions about investing in human and industrial capital over the longer term. Prudent fiscal policies give governments more leeway in combating downturns, while low debt-servicing payments release more resources for social policies. Monetary policies aimed at keeping inflation low and stable also make planning for the future easier. Especially in developing countries and emerging market economies, high and/or erratic inflation hits poorer households which have low or no access to financial markets, and whose financial assets are mainly held in the form of cash.

Fiscal policy can contribute to economic stability while mitigating income inequality. Tax and social benefit systems redistribute a significant proportion of market incomes, but less than formerly. Until the mid-1990s, tax-benefit systems in most OECD countries

offset a little more than half of the rise in inequality in pre-tax incomes. Since then, cuts in benefits relative to earnings, and tighter eligibility have reduced the redistributive impact of the systems, which now on average reduce the Gini measure of inequality by about one quarter. At the same time, inheritance and estate taxes have trended down in recent decades, and personal income tax codes have become less progressive, reducing the redistributive potential of tax-benefit systems. In some countries, the combination of sharply rising incomes at the top end and benefits directed to the poorest has resulted in falling shares of income for the middle classes. Tax-benefit systems are considerably less redistributive in developing and emerging market economies due to weaker social safety nets and less progressive tax systems than in the OECD.

Where desirable, measures can be taken to finance additional redistributive spending. Raising marginal tax rates on high incomes faces public resistance, and transferring more resources to those on low incomes poses budgetary challenges. Nevertheless, there is still a lot of room for raising more tax revenue by combating tax avoidance and evasion, reducing those tax expenditures that chiefly benefit the better-off, and raising tax rates on immovable property, as well as taxes and duties on intergenerational wealth transfers. As incomes rise in developing countries and emerging market economies, and the relative size of the informal sector falls, putting in place more ambitious education and comprehensive social protection systems should be a priority, as should switching emphasis to taxing incomes rather than extensive reliance on indirect taxes and customs duties.

Structural policies are at the heart of Inclusive Growth

Policies can tackle unemployment and in-work poverty without hampering labour market efficiency. Unemployment insurance softens the blow to labour earnings, enabling the unemployed and their dependents to stay out of poverty, up to a limited amount and for a limited time. The priority is to help the unemployed back into productive employment, but there is a trade-off. Replacement ratios which are too generous combined with long periods (more than one year) of eligibility and limited assistance with job search reduce both the incentive and the chance to return to employment. A combination of high replacement ratios made conditional on strictly-enforced work-availability requirements, as part of a well-designed “activation” package (which might include temporary hiring subsidies, especially for youth) compounds both efficiency and strong social protection. Accompanied by sufficient flexibility in hiring and firing, this results in lower unemployment rates and higher material living standards. At the same time, in-work benefits targeted towards poor households are a tested way of encouraging those of a working age to seek, or remain in, employment (although they might weaken incentives for human capital investments through education or training). In developing countries and emerging market economies, where in-work poverty is strongly associated with holding an informal-sector job, conditional cash transfers help mitigate the effects on the poorest households.

A broad range of actions can make education policy more growth-friendly and pro-inclusive. Education is more effective the earlier it starts. The OECD’s Programme for International Student Assessment (PISA) shows that children who have enrolled in pre-school education perform better throughout their education life and tend to be better integrated socially. More investment to increase pre-school enrolment among economically and socially deprived households should therefore be a priority. Also, early tracking (at the lower-secondary level) should be avoided, as it discourages students assigned to lower tracks and encourages early drop-out. Grade repetition is expensive and has little impact on

results. Moreover, school choice should be managed to avoid socio-economic segregation, and upper-secondary pathways need to be carefully designed to encourage completion by allowing two-way passage between different streams, and ensuring that completed secondary schooling leads to a qualification, either academic or VET. In developing countries and emerging market economies, the priority is to ensure that all children enter education and remain there to at least lower-secondary level. Another challenge is to ensure that those students that exit education after secondary level (the great majority) have learned skills that are relevant to their local job market. This is particularly relevant for girls in some countries, who also face traditional gender-based prejudices related to some types of employment.

Pro-competition reform in product markets can do much for growth and inclusiveness, but there are trade-offs. When firms compete with each other and new markets entrants, they have strong incentives to innovate and keep prices low, which is good for growth and benefits consumers. Poorer households suffer most from the existence of cartels and monopolies in markets for goods and services that account for a high share of their budgets. Lack of competition in network industries, such as utilities and telecommunications, also tends to hit poor households and entrepreneurs the most, depriving them of affordable services. Moving to stronger competition is therefore supportive of Inclusive Growth, although in the short term stronger competition can create losers as well as winners. Compensatory policies, ranging from labour market interventions to social safety nets, can help cushion workers who may lose their jobs as a result of heightened competition. Lifting subsidies on basic foodstuffs and fuels, especially those which are environmentally harmful, leads to better resource allocation and less damage to the environment, but the effects of such changes can be regressive, meaning that the poorest households might need targeted compensation. Another important channel for increasing the distributional effects of competition policies is greater firm turnover, as poorly performing firms exit the market and more productive ones prosper, which fosters job creation and entrepreneurship.

Innovation policies tend to focus on productivity and growth objectives, rather than on how the fruits of growth are distributed. Economic growth depends on the creation of new or improved products, and better ways of producing and distributing them. But moving to new technological paradigms and an innovation-intensive economy will benefit some groups in society (namely those holding assets and skills required) more than others. This was the case with the “digital revolution”, which has introduced rapid and fundamental technological change. Trade-offs between growth and inclusiveness can arise where policies focus strongly on supporting innovation in leading businesses, research institutions and activities. Such strategies provide few opportunities for those outside “islands of excellence”. By contrast, innovation policies aimed at enabling “bottom-up” initiatives can do much to create synergies that support Inclusive Growth. Indeed, increasing Internet access and encouraging local initiatives that provide platforms for entrepreneurs – like the widespread use of mobile telephony in some developing countries and emerging market economies for facilitating small-scale money transfers between individuals, and transmitting market information between small-scale enterprises – show that new technologies can facilitate grassroots innovations tapping into the creative capacity of excluded populations.

Entrepreneurship which creates new ideas and products, and exploits niches that others have missed, should be open to all. In practice, entrepreneurs tend to be prime-age males from well-off households, in large part because it is a risky full-time activity,

many start-ups fail, banks are reluctant to lend to those with inadequate collateral, and women in particular may face problems in reconciling family commitments with extra work demands. In developing countries and emerging market economies, would-be entrepreneurs from the poorer strata of society, often in the informal sector, face even greater barriers, especially in access to finance. As for immigrant would-be entrepreneurs in OECD countries, they may have to rely on finance from family and friends. Policies to make entrepreneurship more inclusive include financial assistance in the form of competitively-based awards, soft loans or monthly payments to the unemployed who wish to start a business, better provision of child-care facilities, and establishing networks of education involving experienced entrepreneurs. Above all, more progress needs to be made in reducing bureaucratic hurdles.

Financial sector developments raise challenges to small businesses and savers and often exclude the disadvantaged. The *raison d'être* of the financial sector, to channel savings from households to firms, has been increasingly overshadowed in recent decades by rising trading in ever-more sophisticated variants of financial assets within the sector itself, a profitable but riskier business. The global crisis showed how risky financial transactions can result in mass unemployment in the real economy, indicating that the incentives facing market participants need to be much more closely aligned with the economic and social goals of societies at large. Because it is not the business of governments to tell firms how they should finance themselves, it is desirable that the fiscal implications of different forms of finance should be as neutral as possible. Fostering financial education and consumer protection is also essential to improve financial inclusion of the most vulnerable groups.

More should be done to assess the impact of structural policies on different population groups

The *OECD Framework for Inclusive Growth* allows for gauging the effects of structural policies on different social groups, such as the middle class and the poor. GDP per capita and average household disposable incomes tend to move in parallel, at least over sufficiently long periods. But specific pro-growth structural policies affect GDP per capita and household disposable incomes differently, with different effects for different social groups along the distribution of income. For example, reforms to reduce regulatory barriers to domestic competition, trade and inward foreign direct investment can lift the incomes of the lower-middle class by more than they do GDP per capita. Conversely, a tightening of unemployment benefits for the long-term unemployed, if implemented without a strengthening of job-search support and other activation programmes, may lead to a decline in the income of the lower-middle class, even if it boosts average income.

A full analysis of Inclusive Growth requires assessing the effects of structural policies on non-income dimensions. While income effects for the middle class are a vital element in policy assessment, analysing the effects of structural policy on health and jobs is equally important for gauging policy determinants of living standards. Certain structural policies may not be immediately beneficial for GDP growth or median household income (for instance increased tax-financed health care expenditure) but may yield health benefits that ultimately contribute to productivity and economic growth. Other structural policies that help both the income and employment prospects of the representative household will show up as particularly desirable as they positively affect two drivers of living standards, income and jobs. These multidimensional effects need to be worked out more systematically, as assessment is crucial for valuing trade-offs and synergies from structural policies.

Well-functioning infrastructure and public services help growth and contribute to both healthier lives and improved job opportunities

Well-designed and well-regulated open access infrastructure boosts both growth and inclusiveness. In all countries, the poor derive the greatest relative benefit from access to public infrastructure in the form of transport, drinking water, sanitation, electricity supply, education and healthcare. Increasingly, access to mobile telephony and broad-band Internet has also become fundamental as a means for the disadvantaged to better integrate into society and the economy. Creating and maintaining infrastructure is a powerful investment for Inclusive Growth, and an expensive one. The experience of many countries shows that restrictive regulation and/or state monopolies are not necessarily – and not usually – the best solution. Ultimately, the priority is to deliver services to the vast majority of the population at least cost. Private investment, competition between providers, regulations that do not discourage change, and innovative financing, can all help.

Better transport and energy infrastructure can spur growth and improve inclusiveness in cities. However, there are efficiency and equity trade-offs when implementing new urban transport systems. New mass-transit systems and motorways save time for those who use them, but the value of the time saved and the impact on congestion elsewhere in the transport network needs to be taken into account. If they are insensitively designed, they can also divide communities and engender social exclusion and isolation. To ensure inclusive outcomes, the planning and implementation of new systems or extensions should focus on citizens' ability to access urban amenities. Better energy infrastructure can help combat "energy poverty", which is often present in developing countries, but large-scale investment is needed to expand access. In mature economies, virtually all households have access to electricity and clean cooking facilities, but some cannot afford to pay for adequate heating, and action is needed to combat this "fuel poverty".

Inequalities and the problems to which they give rise have a spatial dimension that policy makers cannot afford to ignore. Local governments have an important role to play, alongside national governments, in the design and implementation of Inclusive Growth strategies. Cities are places of innovation and economic dynamism but they also face high levels of inequality and social segregation. Low-income groups tend to live in more distressed areas with limited access to public transport, quality education and job opportunities. In addition, large cities tend to have higher costs of living, particularly with respect to housing, which reduces the purchasing power of low-skilled workers. While arrangements differ across countries, local governments are key actors in the delivery of basic urban services, education and often health care, and in many places they are taking on increasing responsibilities for social protection, workforce training and active labour market policies. Local governments are also often at the forefront of pro-growth policy making in such essential areas as the provision of infrastructure and the regulation of business operations.

Inclusive Growth at the urban level requires improved co-ordination across sectoral policies to better manage trade-offs and realise potential synergies among competing objectives. Neighbourhood regeneration initiatives may improve opportunities for business and homeowners, but they may also push up rents and displace the disadvantaged. The quality of life and the productivity of disadvantaged populations may be better enhanced by investments in human capital, essential services and quality housing than in highly visible investments in physical infrastructure and discrete development projects. There is a need for more integrated strategies for cities that link different sectoral policies,

such as housing, transport, skills, employment and the environment. Comprehensive investment in public transit can open up new employment and training opportunities for the most disadvantaged, thus promoting both growth and equity objectives, but it may need to be accompanied by improved training and activation policies. Similarly, locally-driven strategies that address the skills of the regional workforce, targeting the low-skilled, regenerating distressed neighbourhoods, and ensuring affordable housing, help to foster both competitiveness and inclusiveness.

Strategies for structural transformation in developing countries need to focus on job creation and poverty alleviation; and aid policies can play a key catalytic role

Job creation, including quality jobs, is a necessary step towards Inclusive Growth in developing countries. Fast growth of GDP in several developing countries has helped to lift hundreds of millions of people out of acute poverty. However, in many countries fast growth has also widened income gaps between the better-off and those who have been left behind with no jobs, or bad jobs. Countries can facilitate a structural transformation that fosters both employment and growth through policies that keep demand high while boosting productivity in low productivity sectors, and facilitating movement of labour to high-productivity sectors. Many developing countries still have significant potential to increase agricultural productivity, for instance through mechanisation and improving investment practices or by providing credit support and land tenure security to smallholders. In manufacturing-based economies, productivity improvements and upgrading can be fostered by supporting small and medium-sized enterprises to facilitate access to finance. Generally, governments should make sure that the education system (including vocational and on-the-job training) provides in-demand skills to the labour force to support the transition towards higher productivity industrial activities and services.

Development assistance can be effective in promoting Inclusive Growth, particularly in the least developed countries. Official development assistance can catalyse Inclusive Growth, ameliorating social conditions through support for health, education and poverty alleviation programmes while also accelerating structural transformation by financing infrastructure investment, building government capacities and improving the business environment. Aid is an especially important factor for fragile states and the least developed countries where it remains the dominant source of external development finance. To enhance its effectiveness and given the limited resources available, aid should focus on well-defined programmes that bring proven technologies to poor communities, improve framework conditions for small businesses and also democratic governance, and importantly support conditional cash transfer programmes that encourage poor households to keep their children in good health and in education.

1.5. For Inclusive Growth to work well, the appropriate institutions have to exist, and citizens must feel that they can trust them

Political and economic disparities tend to reinforce each other. Across the OECD, electoral turnouts are falling, and socio-economic disparities exist: adults with a tertiary education degree have a general election turnout 12% higher than those with secondary education or less, and older adults are more likely to vote than younger citizens. The risk is that the views of some socio-economic groups are better reflected in the design and implementation of policies and that policy making itself is captured by the interests of the most privileged groups, who may also contribute to the financing of increasingly

expensive political campaigns. Well-designed institutions can help improve transparency and contestability, notably by establishing freedom of information legislation and the right to petition governments, opening lobbying to scrutiny, and setting up commissions of enquiry.

The way policies are designed and implemented matters for Inclusive Growth. An inclusive policy process must be well informed and reflect the public interest. As such, it should be inclusive across the policy cycle, which requires effective and representative citizen participation as well as mechanisms to curb the undue influence of money and power. Increasingly, governments are partnering with the civil society in the design, implementation and evaluation of public policies. For example, participatory budgeting, like that undertaken by Seville authority in Spain or the Toronto Community Housing Corporation in Canada, provides taxpayers with a say in how public funds are spent on the services that affect them. A number of countries are introducing practices of co-production of public services, such as the São Francisco water supply project in Brazil that engages key stakeholders in service planning and delivery. The involvement of the community is seen not only as a way to increase inclusiveness, but also as one of the solutions to address service failures and improve policy outcomes.

New technologies can play an important role in strengthening inclusiveness in policy making and implementation, by enabling new forms of collaborative and participatory governance. New technologies with open data can help governments actively engage with stakeholders and help deliver services which better respond to specific needs. Yet the use of ICTs also raises important challenges for governments. These challenges are related not only to citizens' privacy but also to the new and yet unknown consequences of a new governance model in which the responsibilities for some public policies are shared with or transferred to citizens.

Inclusive policy making and service delivery requires an effective decentralisation of policies which allows better targeted place-based policies. Subnational governments are often much better positioned to plan and manage investment and service delivery "at street level". Yet, effective decentralisation for Inclusive Growth requires a solid whole-of-government co-ordination and a clear division of responsibilities for the actions taken at the different levels of government.

Chapter 2

The many dimensions of inequality and poverty

To what extent has inequality grown in the advanced economies over the last thirty years? How has the picture changed in emerging economies and developing countries? This chapter answers those questions by exploring trends in income inequality, and examining how individuals at different segments of the income distribution fare across a number of non-income measures related to well-being, including: education, health, employment, and exposure to environmental degradation. The picture that emerges is far from uniform, but there is a clear trend towards increased inequalities in OECD countries, as well as persistently high inequalities in emerging and developing countries, despite some improvements in many cases. The chapter goes on to consider the spatial distribution of both income and non-income outcomes, charting the geographic divides and concentrations of poverty that occur within countries, regions and cities.

Inequality is on the rise in OECD countries and remains very high in non-OECD countries. Until recently, economic growth was considered as the most important policy objective in a majority of countries. This was true irrespective of their stage of development and of the particular phase of the business cycle. Part of the motivation for the emphasis given to economic growth relies on the assumption that growth will automatically deliver higher welfare to people. Recent research has challenged this assumption (Stiglitz et al., 2009). First, economic growth may only increase *economic* well-being (i.e. people's consumption opportunities) for a limited number of people in the population. Second, economic growth may not necessarily translate into higher *non-economic* outcomes (e.g. health, environmental quality, etc.) that are essential for people to participate fully in the economy and society more broadly. Hence, *how* countries grow and *whether* this growth translates into greater benefits for citizens, i.e. whether growth is inclusive, matters in a fundamental way.

This chapter provides an overview of trends in the distribution of income and non-income dimensions that matter for Inclusive Growth. The non-income dimensions include labour market status, education and skills, health and environment. The regional dimension is presented as an underlying issue affecting several outcomes.

2.1. Income inequalities and poverty

Widening income inequalities: A global trend?

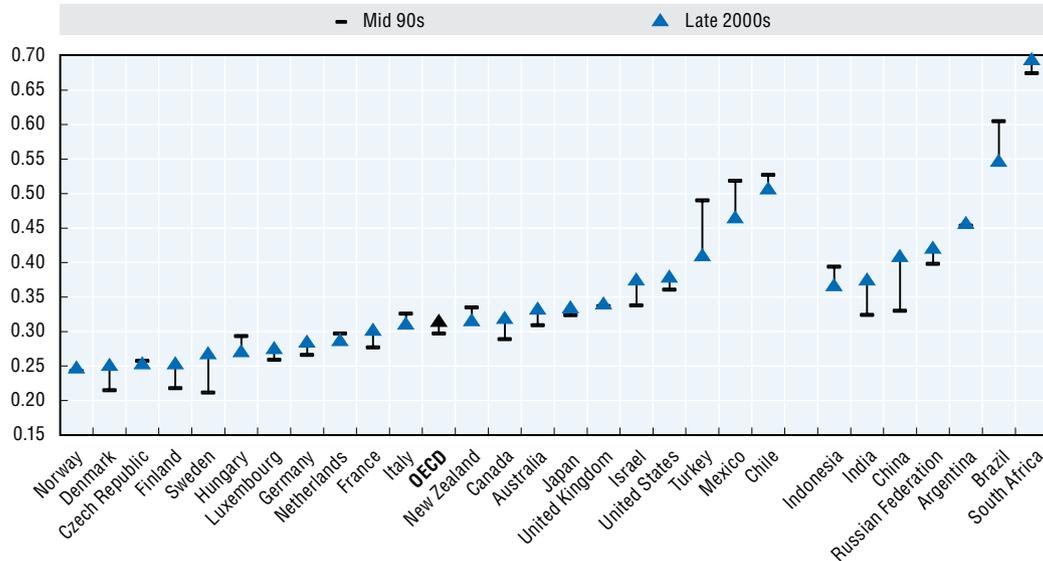
Income inequality has widened in most OECD countries over the last 30 years. The Gini coefficient, a standard measure of inequality increased from 0.29 in the mid-1980s to 0.32 in 2010 on average in OECD countries (Figure 2.1).¹ The gap in income between rich and poor, which is another conventional gauge of income inequality, has also widened in OECD countries: in 2010, the average income of the richest 10% of the population was around 9.5 times that of the poorest 10%, against about 7 times 30 years ago (OECD, 2011b and OECD, 2013a). Income inequality is increasing even in OECD countries like Germany, Denmark and Sweden, where it has traditionally been low. A growing concentration of income among the top-income earners is among the key drivers of rising inequality in many OECD countries (Figure 2.2). In the United States 47% of total income growth over 1976-2007 went to the top 1%, in Canada it was 37%, and the figure stood at around 20% in Australia and the United Kingdom (OECD, 2014b).

The economic crisis has further exacerbated the increase of market income inequalities in OECD countries. Excluding the mitigating effects of the welfare state, market income inequalities (i.e. income from work and capital) increased as much in the

first three years of the crisis as they did in the twelve years prior to the crisis (Figure 2.3). Even after accounting for taxes and transfers, inequality increased in several countries, including France, Greece, Ireland, Italy, Slovak Republic and Spain, where previous improvements in income inequality were partly or fully reversed. In Iceland, Portugal and New Zealand, the opposite occurred with richer households bearing more losses than poorer ones (OECD, 2013a).

Figure 2.1. **Income inequality has increased in most OECD countries and emerging market economies**

Gini coefficient of disposable income (mid 90s to 2009-10)

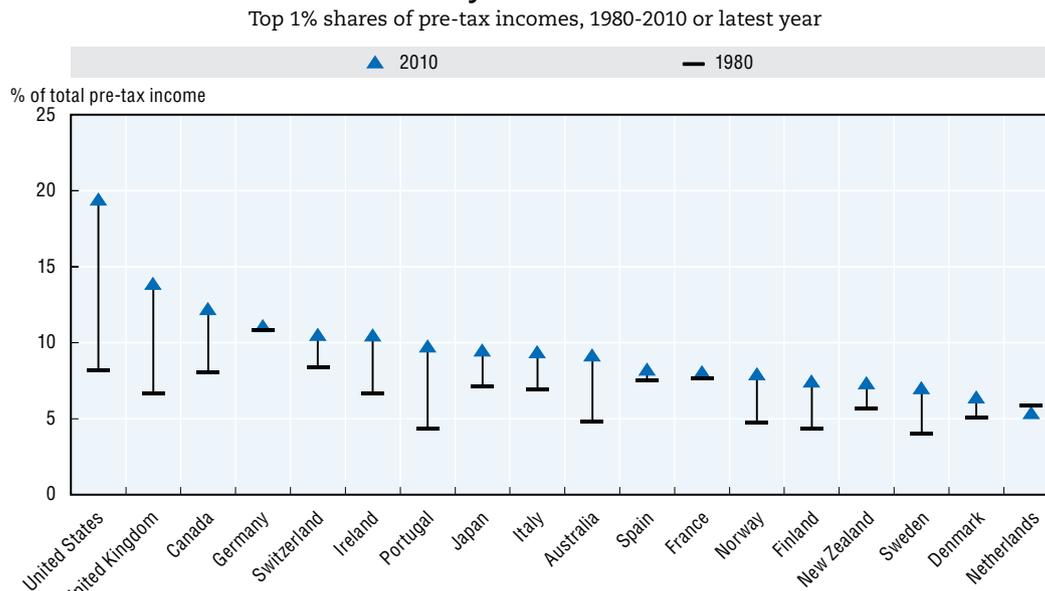


Note: Income inequality is measured by the Gini coefficient based on equivalised household disposable income (after taxes and transfers for total population) for OECD countries and per capita incomes for the emerging market economies outside the OECD area, except India and Indonesia for which per capita consumption was used. Data refer to 1992 for Czech Republic, to 1991 for Hungary. Data for emerging market economies outside the OECD area for the early 1990s (generally 1993), whereas figures for the late 2000s generally refer to 2008. Gini index measures the extent to which the distribution of income or consumption expenditure among individuals or households within an economy deviates from a perfectly equal distribution. A Gini index of 0 represents perfect equality, while an index of 1 implies perfect inequality.

Source: OECD Income Distribution Database (www.oecd.org/social/inequality.htm), OECD, Paris. OECD (2011b), "Special Focus: Inequality in Emerging Economies", in *Divided We Stand: Why Inequality Keeps Rising*, OECD Publishing, Paris. World Development Indicators (WDI) Database, World Bank, Washington, DC.

Income inequality has nevertheless narrowed, but remains high, in many developing countries and emerging market economies (Figure 2.4). Despite a narrowing of income gaps that has taken place since the 1990s in many parts of the world, especially in Latin America, income gaps between rich and poor remain much higher in those countries than in the OECD area (Figure 2.5). This is the case in Brazil, where the ratio between the richest 10% and poorest 10% still stands at 50:1. And in South Africa, inequality has continued to rise and now it is over 100:1 (OECD, 2011b). In China, income disparities actually increased from the early 1990s to 2005, but they began to fall again more recently (OECD, 2013e).

Figure 2.2. **Concentration of income among top earners has increased in many OECD countries**

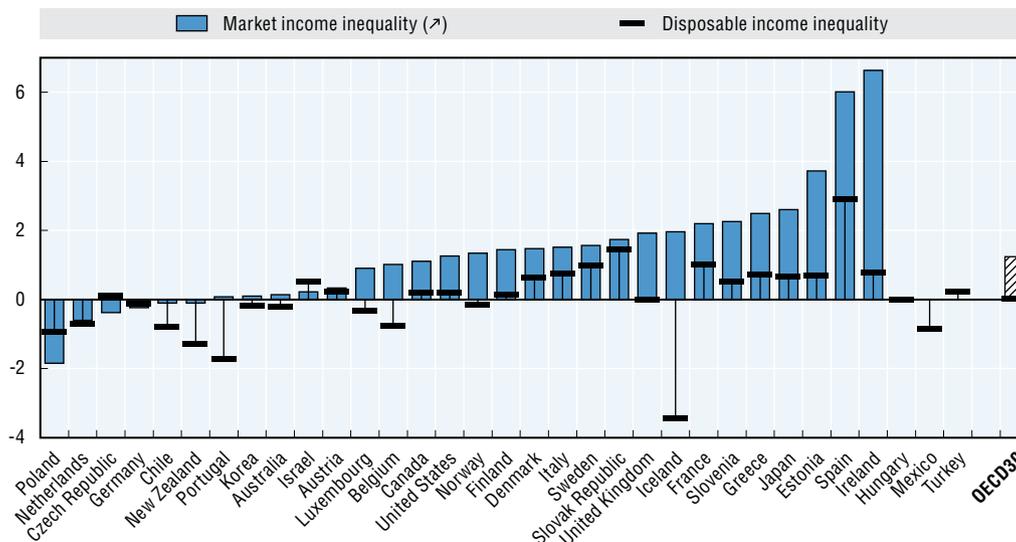


Note: Data refer to the years in parentheses in the following countries: US (2012); Norway (2008); France, Italy and Finland (2009); Portugal (2005); Sweden (2011); Germany (1998) and the Netherlands (1999).

Source: Förster, M. et al. (2014), "Trends in Top Incomes and their Taxation in OECD Countries", *OECD Social, Employment and Migration Working Papers*, No. 159, OECD Publishing, Paris, <http://dx.doi.org/10.1787/5jz43jhlz87f-en>; Top incomes data based on *World Top Incomes Database (WTID)*, <http://topincomes.parisschoolofeconomics.eu/>.

Figure 2.3. **Market income inequality rose considerably during the first years of the crisis**

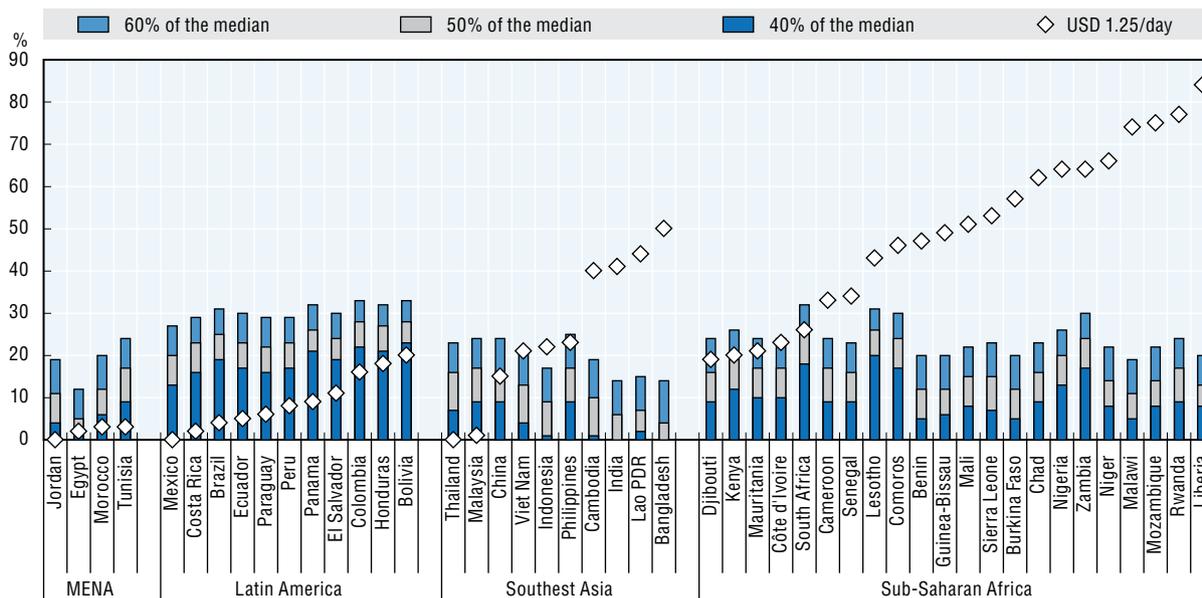
Percentage point changes in the Gini coefficient of household market and disposable incomes between 2007 and 2010



Source: OECD (2013a), "Crisis Squeezes Income and Puts Pressure on Inequality and Poverty", OECD Publishing, Paris, www.oecd.org/els/soc/Income-Distribution-Brief-Figures&Data.xlsx.

Figure 2.4. In the last decade inequality dropped in several developing countries

Gini coefficients in selected emerging market economies and developing countries, 2000 and 2010

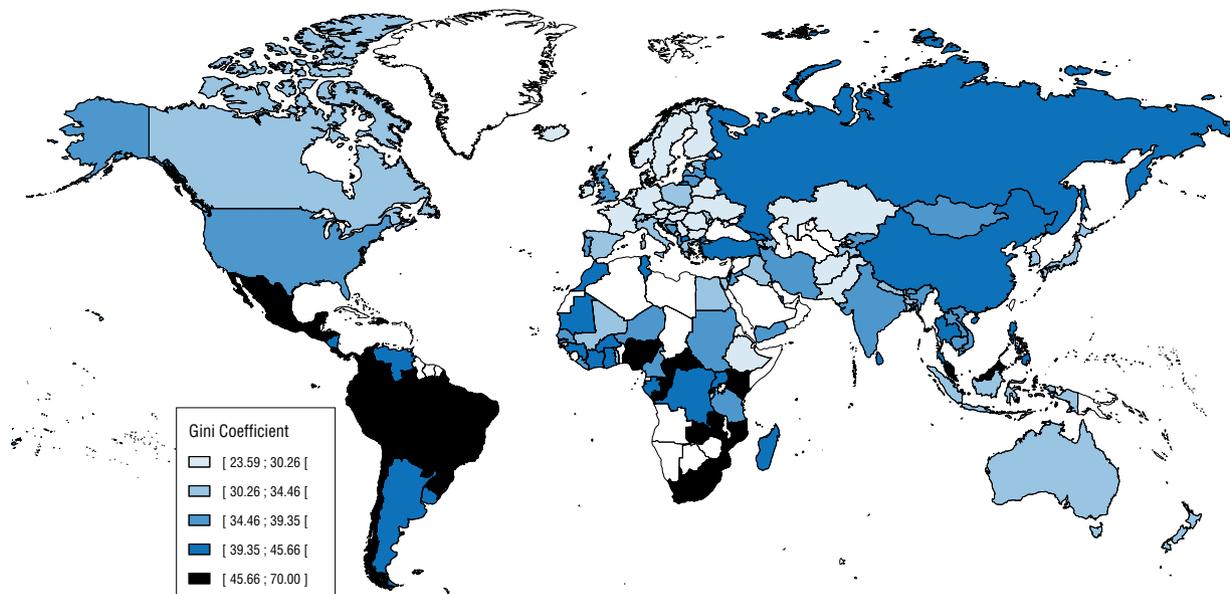


Note: In case of no availability of data in 2000 and 2010, data are collected in the interval of 6 years around each date (3 years before, 3 years after). The choice of welfare measure (e.g. income, consumption expenditure) might impact greatly on any conclusions drawn from the data. As welfare measures in the chart are not strictly comparable across all countries, figures should be interpreted with caution.

Source: World Development Indicators (WDI) Database (2012).

Figure 2.5. The state of income inequality in the world

Gini coefficient (Mid to end 2000)



Note: This map is for illustrative purposes and is without prejudice to the status of or sovereignty over any territory covered by this map.

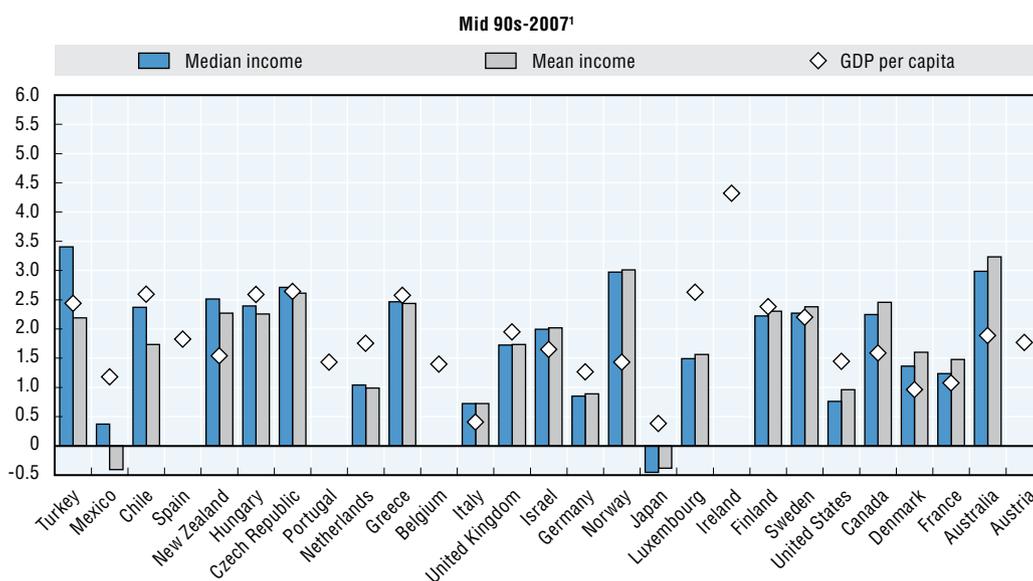
Source: Gini coefficients for OECD countries are from the OECD Database on Income Distribution and are based on equivalised disposable household income for 2008 or latest date available. Gini coefficients for BRICs countries are from OECD (2011b), *Divided We Stand: Why Inequality Keeps Rising*, OECD Publishing, Paris (special focus: Inequality in emerging market economies) and are based on per-capita income (Brazil, China, South Africa) or consumption (India, Indonesia). Gini coefficients for remaining countries and territories are from Standardised World Income Inequality Database (SWIID) for 2005-10 and are based a variety of sources and concepts, standardised to come close to household disposable income. As sources and methods are not strictly comparable across all countries, figures should be interpreted with caution.

2.2. GDP growth and income inequality

In many countries, income inequality has risen while growth in household disposable income has not matched gains in GDP per capita. In over half of OECD countries GDP per capita grew faster than mean household disposable income in the run-up to the crisis (Figure 2.6). This trend suggests that part of the domestic gains in production has accrued to the government and/or the corporate sector.² Even though household disposable income may be underestimated, in particular regarding top income earners a rising discrepancy in the growth rates of GDP and household disposable income could confirm growing income inequality.

Figure 2.6. **Until the crisis GDP per capita was growing faster than household income in many countries**

Average annual growth rates, percentage



Note: For median and mean equivalised household disposable incomes, Purchasing Power Parities (PPPs) are those for private consumption of households. For GDP per capita, PPPs are those for the GDP deflator. Countries are sorted in ascending order according to the difference between the annual average growth rates of mean and median disposable incomes.

1. "Mid 90s" refers to 1995, except for Austria, for which data refer to 1993; Czech Republic, France, Luxembourg and Chile, for which data refer to 1996; Greece, Ireland, Mexico, Turkey and the United Kingdom, for which data refer to 1994. "Late 2000s" refers to 2009, except for Australia, Canada, Denmark, France, Germany, Israel, Mexico, Netherlands, Norway, Sweden, United Kingdom and United States, for which the last available observation is 2010; Korea, for which it is 2011; and Switzerland, for which it is 2008.

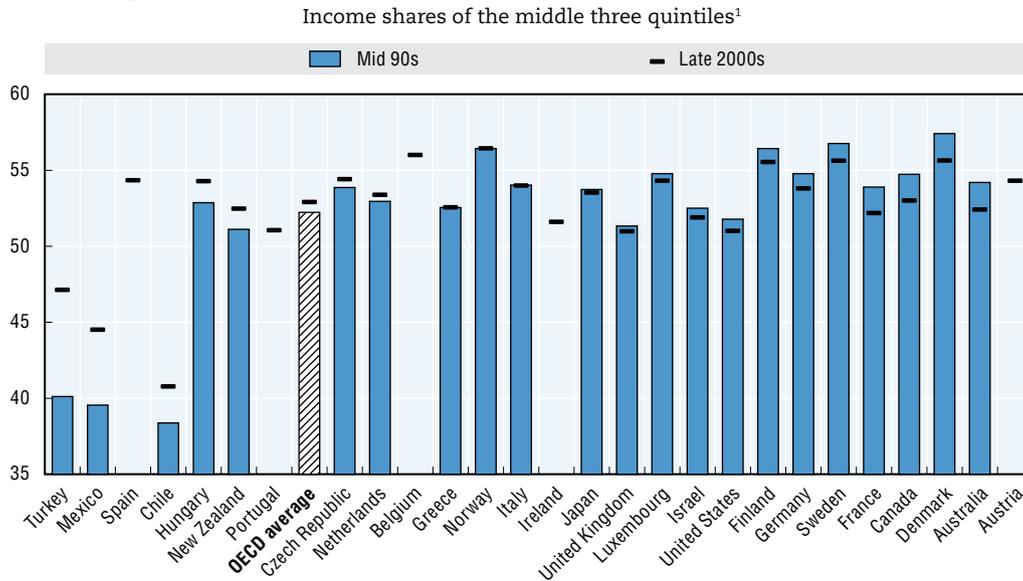
Source: OECD calculations based on *OECD National Accounts* and *Income Distribution Databases*. The databases were accessed in early 2013. Revisions made to the database since then are not reflected in the figure. Due to changes in survey methodologies, figures for Austria, Belgium, Ireland, Portugal and Spain are not fully comparable over time.

2.3. What about the middle class?

In some OECD countries, the middle class has shrunk as a result of rising inequality. Indeed, the concern expressed about the relative impoverishment of the middle class in the United States has recently gained prominence in Europe as well.³ The share of income accruing to the three middle quintiles of the income distribution (i.e. ranging from the 20% to the 80% poorest households), which are conventionally used to identify the middle class, has fallen over time in some countries, including in Austria, Australia, Canada, Denmark,

France and United States (Figure 2.7). In some cases, this outcome has been accompanied by large increases in the share of income accruing to the top quintile, especially in Sweden and Denmark, suggesting that middle-income groups have lost ground relative to the most affluent.

Figure 2.7. **The middle class has shrunk in some OECD countries**



Note: The income distribution is divided into five equally-sized groups referred to as quintiles, where households are ranked according to equivalised disposable incomes.

1. “Mid 90s” refers to 1995, except for Austria, for which data refer to 1993; for Czech Republic, France, Luxembourg and Chile, for which data refer to 1996; Greece, Ireland, Mexico, Turkey and United Kingdom, for which data refer to 1994. “Late 2000s” refers to 2009, except Australia, Canada, Denmark, France, Germany, Israel, Mexico, Netherlands, Norway, Sweden, United Kingdom and United States, for which the last available observation is 2010; Korea, for which it is 2011; and Switzerland, for which it is 2008.

Source: OECD Income Distribution Database. The database was accessed in early 2013. Revisions made to the database since then are not reflected in the figure. Due to changes in survey methodologies, figures for Austria, Belgium, Ireland, Portugal and Spain are not fully comparable over time.

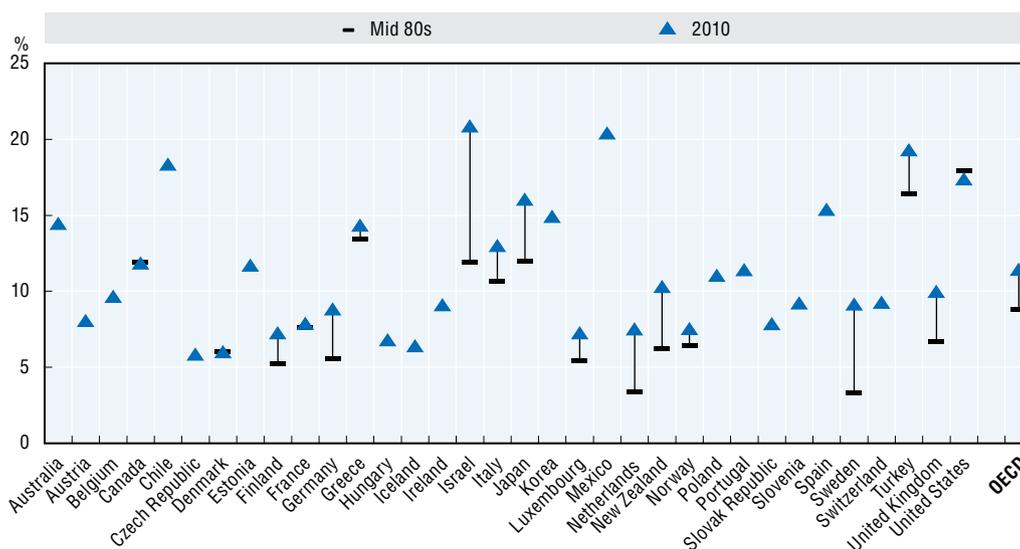
By contrast, strong income growth in emerging market economies and developing countries has led to an increase in the middle class conventionally defined for these countries as individuals living in households with daily per capita incomes of between USD 10 and USD 100 in PPP terms. Estimates of the actual increase in the size of middle classes vary considerably, but there is general agreement that this emerging middle-class remains vulnerable. In Africa, for example, half of the 300 million people belonging to the middle-class are considered at risk of falling back into poverty because of a death in the family or some adverse shock (AfDB, 2011). This vulnerability results from widespread informality in the labour market, as well as limited access to formal safety nets, such as unemployment and health insurance, income support and other social benefits, which cushion individuals and households in more mature economies from income losses as a result of catastrophic events.

2.4. Inequality and poverty

Rising inequality of incomes in OECD countries has been accompanied by rising relative poverty in two thirds of them (Box 2.1). It increased the most – by more than 2 percentage points – in countries that started at low levels (e.g. Finland, Luxembourg and

Sweden), while it fell in some high-poverty countries, such as Chile, Italy and Portugal. On average across OECD countries, the risk of relative poverty has risen from 9% to 11% of the population. It makes up around 19%-21% of the population in Israel, Mexico and Turkey and 16%-18% in Chile, the United States, and Japan (Figure 2.8) (OECD, 2013a). However, there is no mechanical relationship between inequality and poverty; in some countries, poverty has moved in opposite direction to inequality (Figure 2.9, Panel A). Being in poverty is not just about being below the poverty line. Of equal relevance is the question of how far below. On that measure, the “poverty gap” widened in more countries than it narrowed (Figure 2.9, Panel B).⁴

Figure 2.8. Relative poverty rose in many OECD countries
Income poverty rates (per cent of population with income below 50% of the median), mid-1980s and 2010 (or most recent)

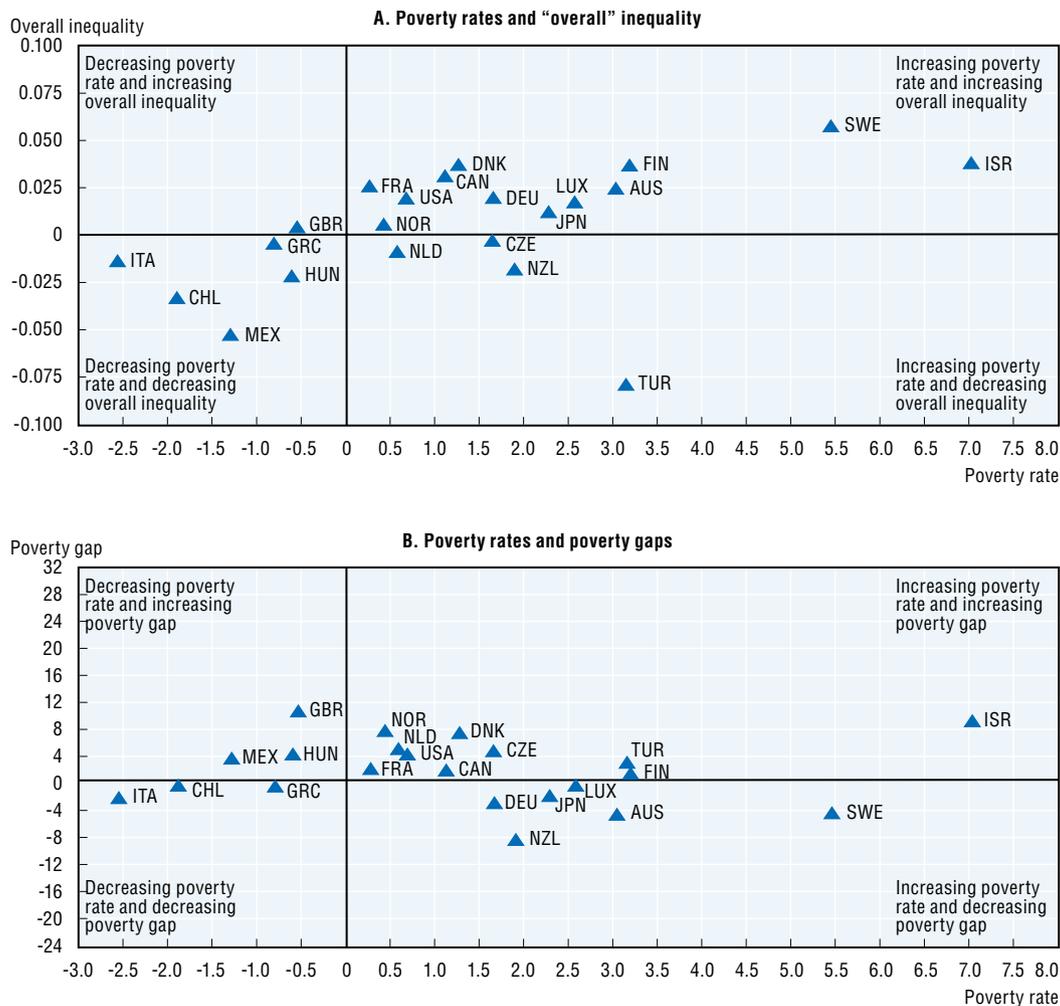


Note: Mid 1980s numbers computed within interval 1983-1987 and data for last year refer to 2010 except for Chile (2011), Hungary, Japan, New Zealand, Switzerland and Turkey (2009). Asterisk (*) after country names indicate break in the series. Relative poverty is defined as the share of persons with income below 50% of the median for their country. Source: OECD Income Distribution Database, www.oecd.org/social/inequality.htm.

Absolute poverty remains a challenge in many developing countries, despite much progress over the years. Sustained economic growth and policy reforms have shifted millions of people out of absolute poverty (Box 2.2). As a result, the developing world has already attained the first Millennium Development Goal (MDG) target of halving the 1990 poverty rate by 2015. In 2010 there were around 700 million fewer extremely poor people than in 1990 (UN, 2013a).⁵ In some fast-growing and highly populated countries, especially China, the share of population below the absolute poverty line fell from 60% in 1990 to about 12% in 2009.⁶ Despite these achievements, almost half of the population in Sub-Saharan Africa still lives on less than USD 1.25 a day; extreme poverty is also widespread in South Asia, and India is home to one-third of the world’s poor.

Figure 2.9. **Widening inequality does not necessarily imply an increase in poverty**

Changes, mid 90s-late 2000s¹



Note: Relative poverty is defined as the share of individuals with equivalised disposable income less than 50% of the median for the entire population while the poverty gap is calculated as the distance between the poverty threshold and the mean income of the poor, expressed as a percentage of the poverty threshold. “Overall” income inequality is measured by the Gini coefficient for household disposable income.

1. “Mid 90s” refers to 1995 except for Austria for which the data refer to 1993, for Czech Republic, France, Luxembourg and Chile for which the data refer to 1996, for Greece, Ireland, Mexico, Turkey and the United Kingdom for which the data refer to 1994. Late 2000s refer to 2009 except for Australia, Canada, Denmark, France, Germany, Israel, Mexico, the Netherlands, Norway, Sweden, the United Kingdom and the United States for which the last available observation is 2010, for Korea for which it is 2011.

Source: OECD Income Distribution Database. The database was accessed in early 2013. Revisions made to the database since then are not reflected in the figure. Due to changes in survey methodologies, figures for Austria, Belgium, Ireland, Portugal and Spain are not fully comparable over time.

Box 2.1. Absolute poverty versus relative poverty measures

Poverty comparisons between developing countries usually focus on **absolute poverty lines** and use an international yardstick, such as the World Bank's dollar-a-day (USD 1.25 PPP per day). Such measures correspond to the minimum survival requirement – the cost of the minimum caloric intake needed to survive or the cost of purchasing a basket of goods assumed to satisfy basic needs (Haughton and Khandker, 2009). Absolute poverty lines are only adjusted for price inflation so that poverty measures are comparable over time.

By contrast, the common practice in the analysis of OECD countries is to use a relative definition of poverty. Individuals or households are considered poor if their income falls below a certain proportion of mean or median income. Eurostat uses a line set at 60% of median income. Similarly, the OECD uses multiple relative poverty lines set at 50% and 60% of median income as a benchmark for international comparisons. While absolute poverty lines depend on an arbitrary definition of what are “basic needs” and how these needs vary across time and places, relative poverty lines have “the unique advantage of being practicable and immediately applicable on a comparable basis” (Atkinson et al., 2002). The most widely accepted argument for the use of relative poverty lines is that they include the cost of social inclusion needed to achieve society's customary living standard (Atkinson, 1995).

Poverty measures derived using relative poverty lines are useful for poverty analysis in both international comparisons and to track progress in reducing poverty over time in developing economies. Comparisons of poverty levels between OECD and non-OECD countries can be better derived with the use of relative poverty lines such as those used typically in OECD countries.

Sources: Garroway, C. and J. de Laiglesia (2012), “On the Relevance of Relative Poverty for Developing Countries”, OECD Development Centre Working Papers, No. 314, OECD Publishing, Paris; Atkinson, A.B. (1995), “Capabilities, Exclusion, and the Supply of Goods”, in K. Basu, P.K. Patanaik and K. Suzumura (eds.), *Choice, Welfare and Development: A Festschrift in Honour of Amartya K. Sen*, Oxford University Press, Oxford. Haughton, J., and S. R. Khandker, S. R. (2009), “Handbook on Poverty and Inequality”, The World Bank, Washington, DC; Atkinson, A., Cantillon, B., Marlier, E. and B. Nolan (2002), “Social Indicators: The EU and Social Inclusion”, OUP Catalogue, Oxford University Press.

Box 2.2. Who are the poor?

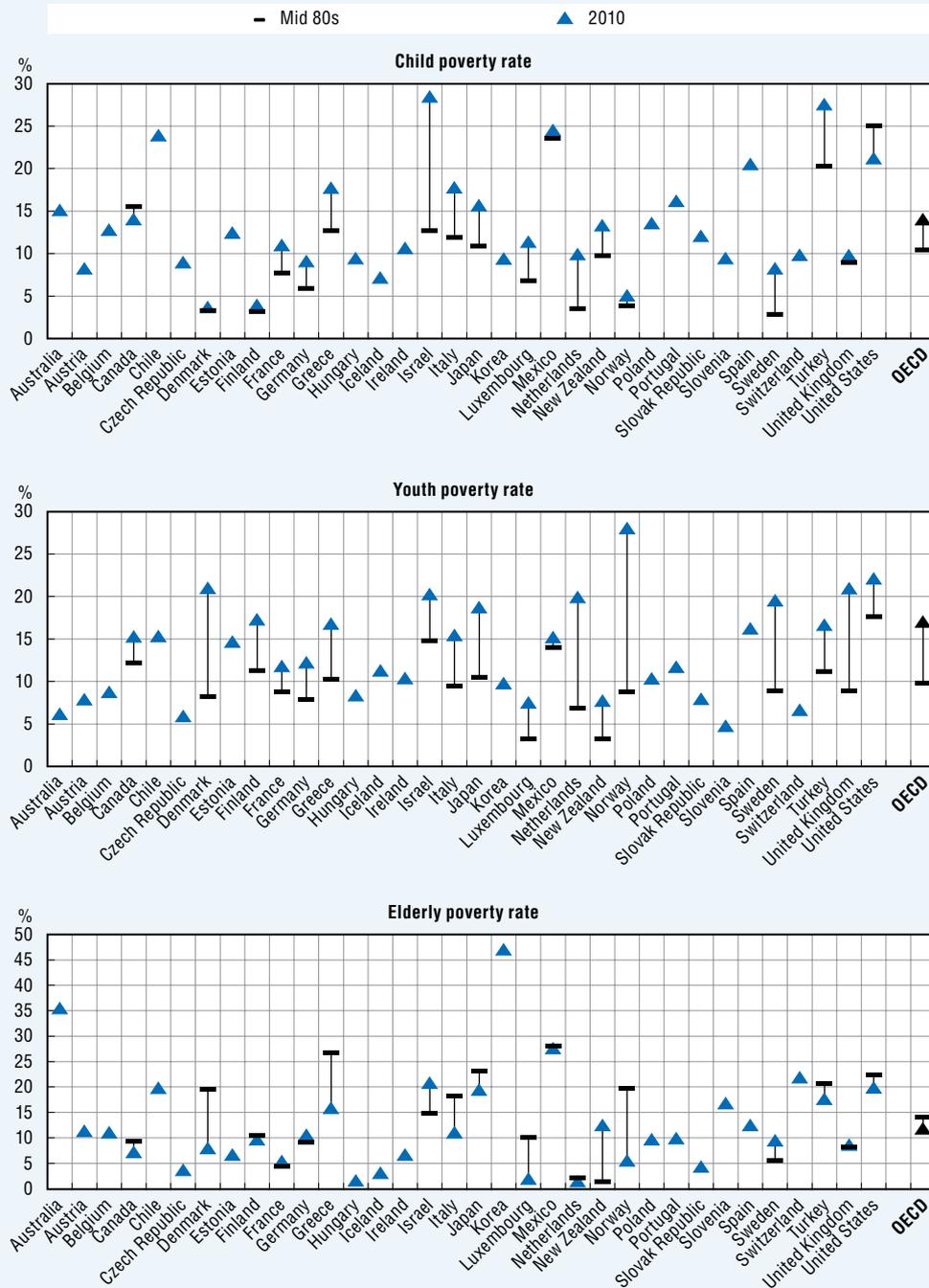
Within OECD countries, poverty rates vary considerably across age groups. On average, across the OECD area, working-age people record the lowest poverty incidence followed by the elderly, children and youth (Figure 2.10).^{*}The majority of OECD countries have a higher poverty rate among children than among the elderly (OECD, 2013a), a trend that has been accentuated over the past two decades. Poverty rates for children and youth have been increasing steadily in many countries since the 1980s.

Women are more vulnerable to falling into poverty than men. Because women often have a looser attachment to the labour market and lower earnings, they are at a higher risk of falling into poverty than men, particularly in old age (OECD, 2008a). Women are more likely to work part-time and are over-represented in lower paid occupations and jobs. Since pension benefits are often earnings-related, these differences in career profiles between men and women can lead to large gender disparities in pension payments. Furthermore, in view of their work history, older women may not meet contributory requirements and are therefore more likely to draw on non-contributory minimum (or low-level) pensions or old-age safety nets. The duration of retirement also affects gender differences in old age poverty risks. Women live longer than men, are more likely to become widowed, live alone, and possibly rely on an often low survivor's benefit (OECD, 2012a).

Box 2.2. Who are the poor? (cont.)

Figure 2.10. **Relative poverty increased among children and youth in OECD countries**

Income poverty rates (per cent of population with income below 50% of the median), by age groups, mid-1980s and 2010 (or most recent)



Note: Mid 80s numbers computed within interval 1983-87, and data for last year refer to 2010 except for Chile (2011), Hungary, Japan, New Zealand, Switzerland and Turkey (2009) Relative poverty is defined as the share of persons with income below 50% of the median for their country. Age groups refer to children 0-17, young 18-25, adults 26-65, elderly 66+.

Source: OECD Income Distribution Database (www.oecd.org/social/inequality.htm).

Box 2.2. Who are the poor? (cont.)

In OECD countries, immigrants are at higher risk of poverty. The risk of poverty for immigrants across OECD countries is on average higher (17.3%) than the risk to the native-born population (8.7%). There are however some OECD countries, such as Estonia, Ireland, Israel, Portugal, Poland and Slovenia, where both rates are comparable and relatively low in international comparisons. In others, the converse is true: in Denmark, Finland, the Netherlands and Norway, as well as in France and Belgium, the immigrant poverty rate is 3.7 to 4.5 times higher than that of the native-born. This is an issue, especially in Belgium and France, where immigrant households represent more than 10% of all households (OECD, 2012k).

In the developing world, extreme poverty affects mainly young populations in rural and agricultural based areas. Almost 80% of the people living with less than USD 1.25 a day reside in rural areas and more than 60% of the poor work in agriculture (World Bank, 2013a). Many poor people are employed but earn too little to lift their families out of poverty. Estimates suggest that poverty is also concentrated in households where the head has no or incomplete primary education (Sumner, 2013). The share of women and men living in extreme poverty is evenly distributed, but poverty rates are highest among children: more than one-third of the people in extreme poverty are under 13 years old. In low-income countries child poverty is even higher, affecting one in two children (World Bank, 2013a).

* Data for 2010.

2.5. The jobs divide: Inequality in labour market outcomes

Trends in the labour markets matter for inclusiveness

Labour force participation and employment rates vary considerably across countries. Almost two in three individuals of working age were employed in the OECD on average in 2012, similar to the situation in 1992. In developing countries and emerging market economies, labour force participation and employment rates have increased since the early 1990s and are on average comparable to those in OECD countries, except for the Middle East, North Africa and Southern Asia.⁷ Certain population groups, including women, immigrants, youth and older workers (although less so in advanced economies) tend to be systematically under-represented in the labour force and have weaker attachments to the labour market.

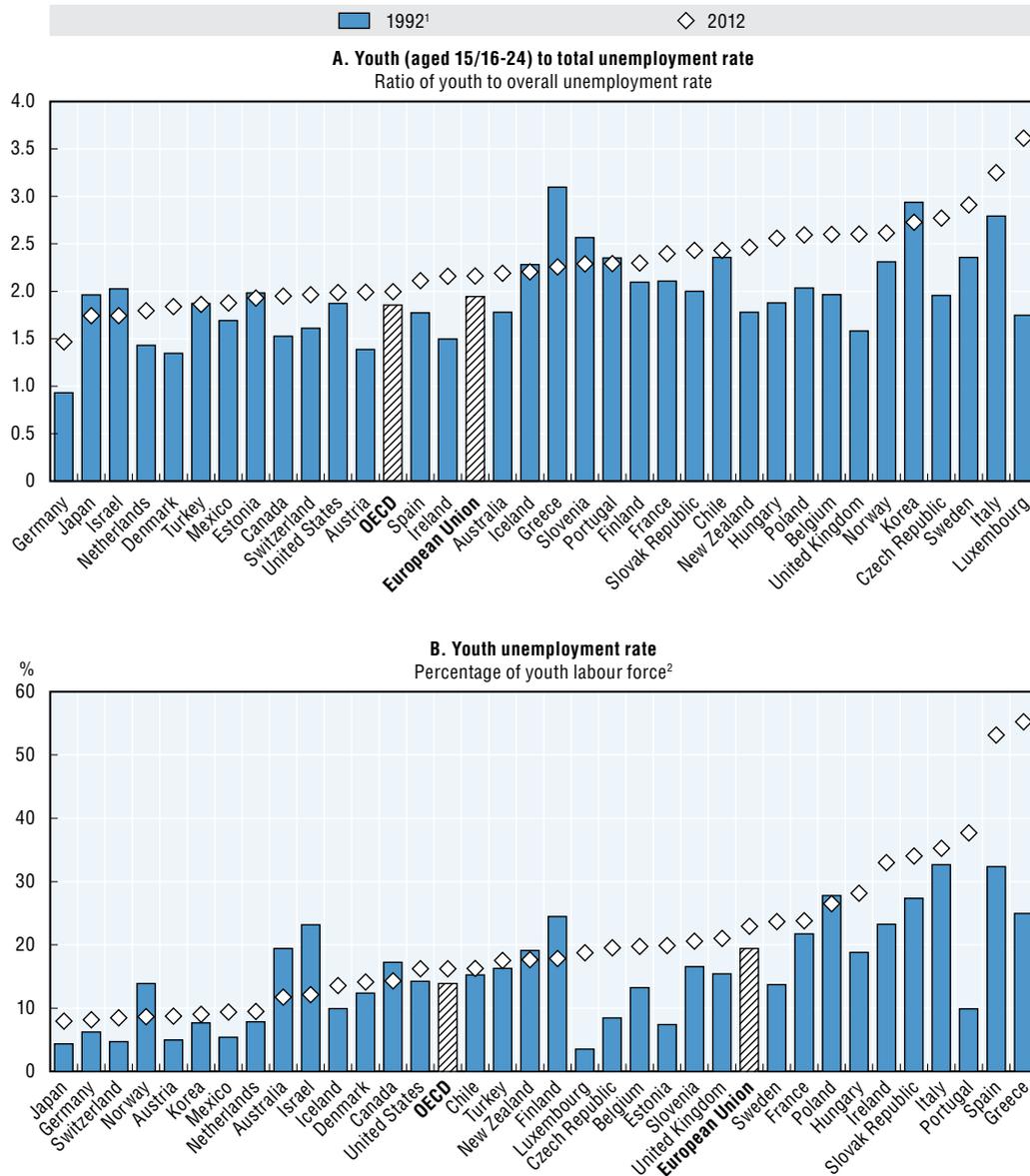
Joblessness rose dramatically as a result of the crisis and risks becoming entrenched. In 2013, the OECD unemployment rate stood at 7.9%, 2.3 percentage points higher than at the onset of the crisis, with unemployment exceeding 25% in Greece and Spain. Although the impact of the crisis on the labour market varies across countries, depending to a large extent on the depth of the shock and the speed of the recovery, there are more than 202 million people worldwide who are out of work, 15 million more people in OECD countries who are unemployed today than when the crisis began in 2007, and millions more in developing countries who have fallen into unemployment.

Out of jobs: Who are affected?

Youth unemployment has become a major concern in OECD countries, where nearly 8 million youths are neither employed, nor enrolled in education or training. The OECD youth unemployment rate is on average almost twice as high as the overall unemployment

rate, and as high as over 50% in Greece and Spain (Figure 2.11). Aside from the impact of the crisis on the labour market, which affects youth joblessness in the short term, difficulties in school-to-work transitions and higher risk of job loss among the young are key factors behind the higher rates of youth unemployment. It is important to tackle youth unemployment because joblessness is highly correlated with poverty and unemployment experienced early on in a career may have long-lasting effects.

Figure 2.11. **Youth unemployment is about twice as high as overall unemployment in OECD countries**



Note: Countries are shown by ascending order of the ratio in 2012 in Panel A and by the youth unemployment rate in 2012 in Panel B.

1. 1993 for the Czech Republic; 1994 for Austria and the Slovak Republic; 1996 for Chile; and 2002 for Slovenia.

2. Ratio of youth (aged 15/16-24) unemployment to the overall (persons aged 15-64) unemployment rates.

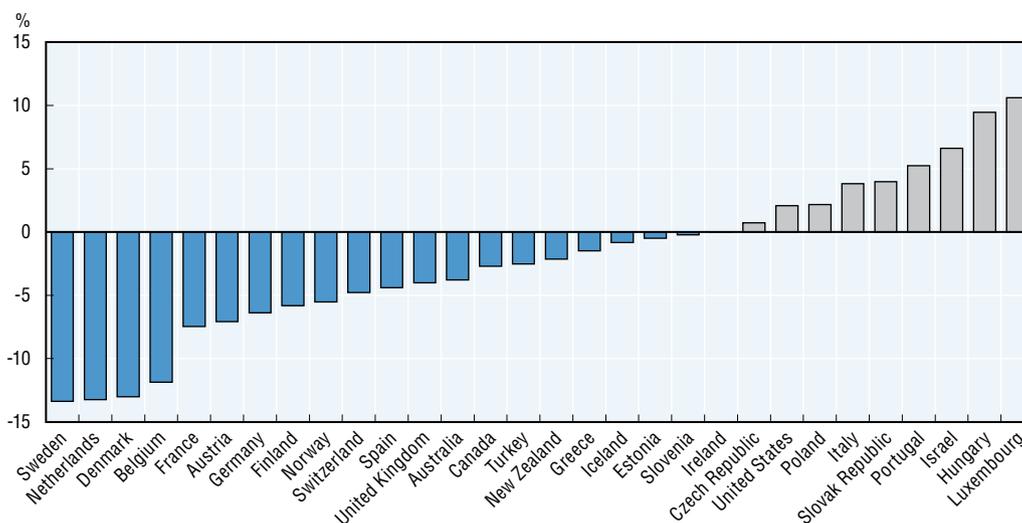
Source: OECD estimates based on the OECD Labour Force Statistics Database.

Youth employment is of particular concern also in developing and emerging market economies where 90% of the youth global labour force is concentrated (ILO, 2012a). As a result of demographics, many young individuals enter the labour force every year, and in some cases economic growth is not strong enough to create jobs for all of them. This leads to joblessness or inactivity, which poses a heavy burden on the growth potential of those economies and puts pressure on society. Youth unemployment is particularly pronounced in Africa, where young people constitute 60% of total unemployed, and more specifically in middle-income countries, such as South Africa (52%, in 2012), Lesotho (35.9%, in 2012) and Tunisia (29.3%, in 2012) (ILO, 2013a).

Immigrants and foreign-born workers are systematically at a disadvantage in the labour market. In several OECD countries, foreign-born workers have lower employment rates than native workers (Figure 2.12). In developing countries and emerging market economies, relatively more porous borders allow low-skilled individuals to enter neighbouring countries more easily than OECD countries, and many of these migrants join the ranks of vulnerable workers in the informal sector. Also, South-South migration flows contribute to enriching the stock of skilled workers in developing countries facing significant skills shortages.

Figure 2.12. Employment rates are lower among foreign-born workers in OECD countries

Percentage-points differences between foreign and native-born employment rates (2012)

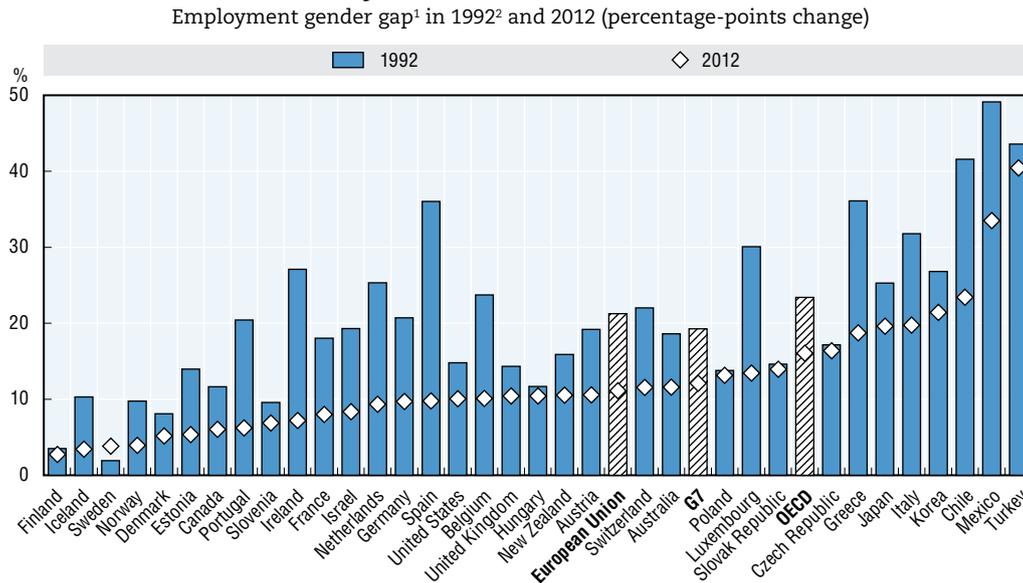


Note: Countries shown by ascending order of the employment gap.

Source: OECD International Migration Database.

The gender employment gap has narrowed worldwide but remains high (Figure 2.13). This largely reflects increased labour force participation among women as a result of rising female educational attainment and increased use of family-friendly policies in OECD countries. Nevertheless, women continue to earn less than men and be less represented in senior management positions. In many developing countries and emerging market economies, gender gaps remain noticeably high, particularly in the Middle East and North Africa, and Southern Asia (OECD, 2012a) (Figure 2.14). In those countries, women are over-represented in vulnerable jobs and informal employment (Box 2.3).

Figure 2.13. **The gender employment gap has narrowed over the last twenty years in OECD countries**



Note: Countries are shown by ascending order of the employment gender gap in 2012.

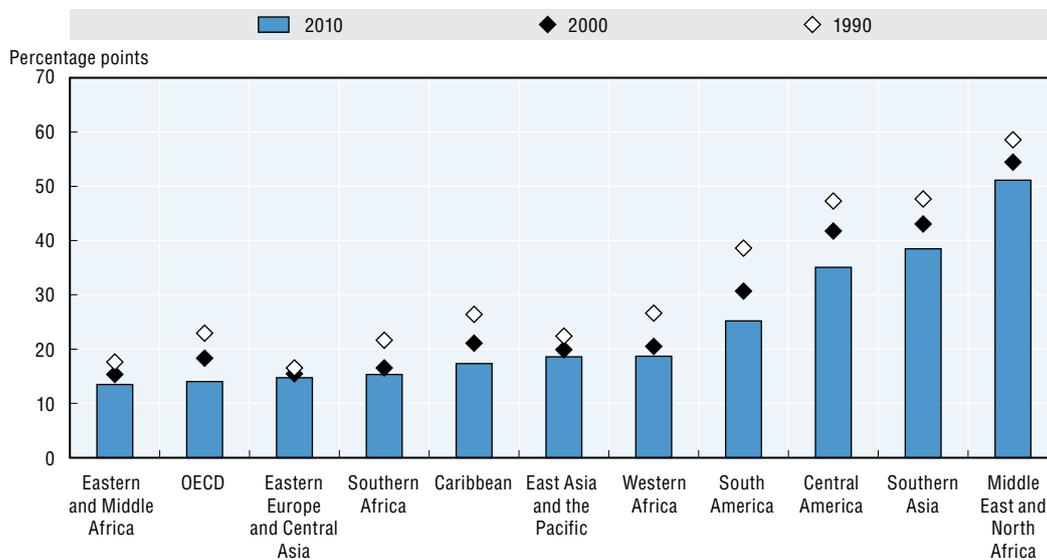
1. Difference in percentage-points between men and women employment rates. (persons aged 15-64).

2. 1993 for the Czech Republic; 1994 for Austria and the Slovak Republic; 1996 for Chile; and 2002 for Slovenia.

Source: OECD estimates based on the OECD Labour Force Statistics Database.

Figure 2.14. **Gender gaps in labour force participation have narrowed almost everywhere**

Gender gap in labour force participation (male rates minus female rates) by world region, 1990, 2000, 2010



Note: Unweighted averages for countries in each region. Regions are arranged from left to right in ascending order of 2010 gender gap in labour force participation. Labour force participation refers to the age 15-64 years old. Data for non-OECD regions includes all economies for which data are available and do not cover any OECD countries.

Source: OECD Employment Database and ILO (2012b), "Key Indicators of the Labour Market (KILM)", 7th Edition, KILM, ILO, Geneva, www.kilm.ilo.org.

Box 2.3. Closing the gender gap: a story of discrimination

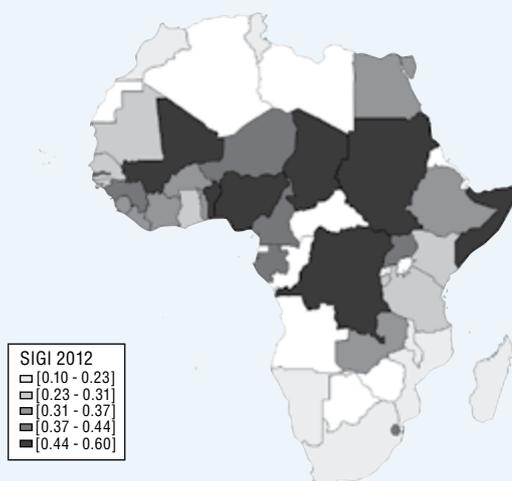
Gender equality is not just about economic empowerment, it is about fairness and equity, and it includes many political, social and cultural dimensions. Many countries have made significant progress towards gender equality, but there is still much room for improvement. The OECD Social Institutions and Gender Index, which measures discrimination against women across non-OECD countries, shows that Sub-Saharan countries have the highest level of discrimination (Figure 2.15). However, there is great variation in the region with countries such as South Africa, Namibia and Rwanda standing apart with strong laws and policies to address discrimination.

In developing countries, investment in gender equality yields the highest returns of all development initiatives. With many countries mandating schooling from around the age of six, primary school enrolment is nearly universal, except in Sub-Saharan Africa. In most developing countries, however, girls are still less likely than boys to enrol in secondary education and have lower rates of participation in the formal labour market.

Gender equality is also an issue in developed countries. Although girls are outperforming boys in some areas of education and are less likely to drop out of school, the glass is still only half-full: women continue to earn less than men, are less likely to make it to the top of the career ladder, and are more likely to spend their final years in poverty. Women in OECD countries earn on average 16% less than men, female top-earners are paid 21% less than their male counterparts. The so-called “glass ceiling” is real: women are disadvantaged when it comes to decision-making responsibilities and senior management positions; by the time they get to the boardroom, there is only one of them for every 10 men.

Figure 2.15. **Discrimination against women is the highest in Sub-Saharan countries**

OECD Social Institutions and Gender Index (SIGI), 2012



Note: The map ranks 37 African countries according to 2012 SIGI. The shades represent quintiles of the SIGI scores for the region: the darkest shades represent the highest level of discrimination. Each country has an overall SIGI score between 0 (low discrimination) and 1 (high discrimination). Countries are not scored if they are missing data for one or more variables.

The Social Institutions and Gender Index (SIGI) is a composite measure of discrimination against women for non-OECD countries. The SIGI captures laws, social norms and practices such as early marriage, violence against women and restricted property rights. It contains 14 variables grouped into five dimensions: Discriminatory Family Code, Restricted Physical Integrity, Son Bias, Restricted Resources and Entitlements and Restricted Civil Liberties. More information at www.genderindex.org.

Source: OECD Gender, Institutions and Development Database and OECD (2012a), *Closing the Gender Gap: Act Now*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264179370-en>.

Jobs do not always expand horizons

Deterioration in job quality

Non-standard employment is widespread. Non-standard work arrangements, including temporary employment (part-time and full-time), part-time jobs on a permanent contract and self-employment, account for one-third of employment on average in OECD countries. It has grown significantly in Austria, Germany and the Netherlands, and almost doubled in size in the Slovak Republic. Over 1995-2010, the share of part time employment has increased in three quarters of the OECD.

Disparities in job quality are increasing. Recent OECD work suggests that economic growth has been accompanied with higher levels of “job strain”, i.e. increased worker psychological demand with minimal decision-making power (OECD, 2012). It is assumed that different levels of work stress are caused by three main factors: the amount of work needed to be done (known as job demands); the degree of decision-making authority an individual has; and the extent to which an individual can choose to employ his or her skills (the sum of the latter two are known as decision latitude). Around 30-40% of workers in the Anglo-Saxon countries and in the Mediterranean basin have seen a large increase in job strain. Job strain has increased substantially in all occupations, workers in low-skilled occupations such as clerks and service workers, are much more likely to suffer from job strain than those in high-skilled occupations, such as lawyers, university professors, consultants or account managers (Figure 2.16).

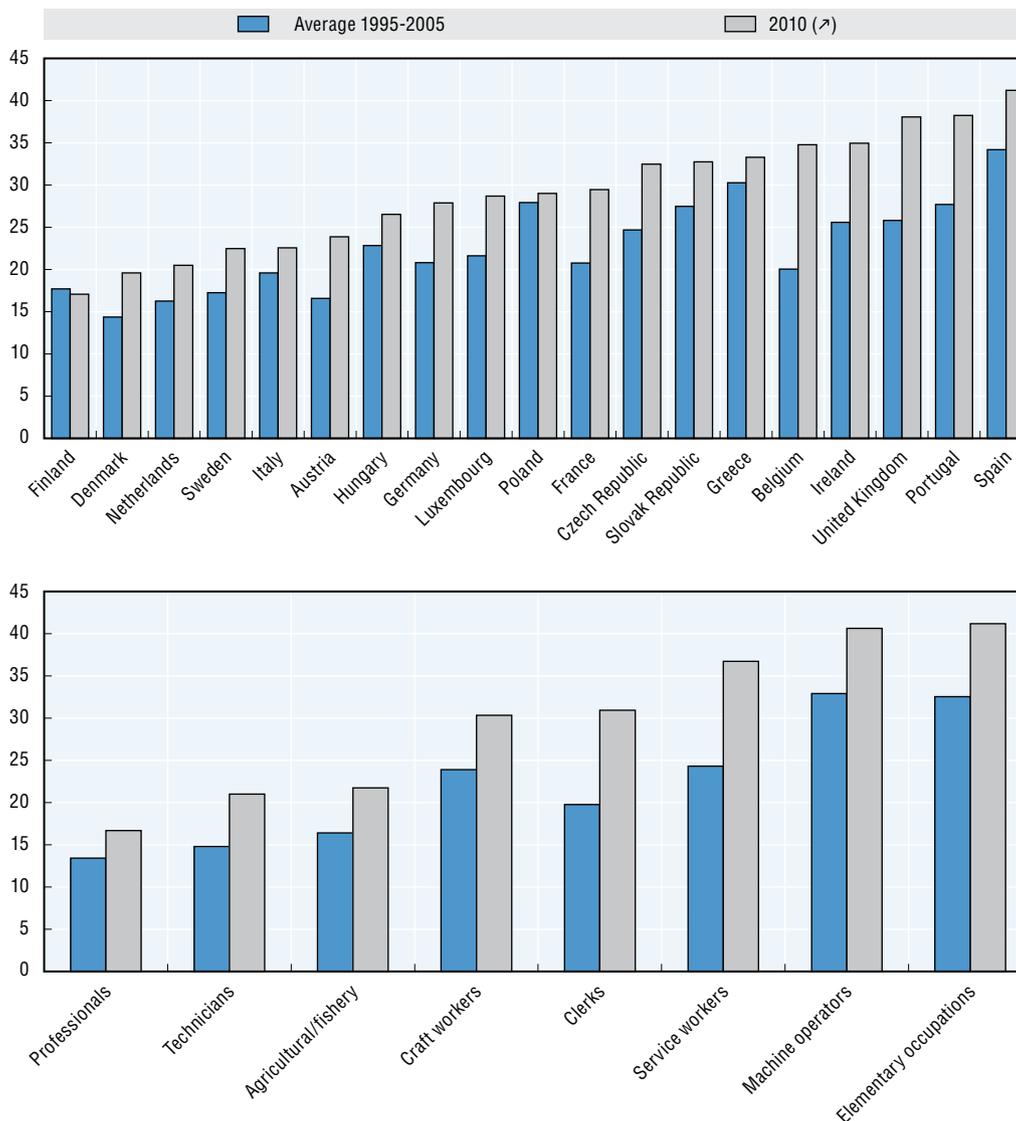
Developing countries and emerging market economies have even higher shares of own-account and contributing family workers in total employment than advanced economies, as well as lower shares of wage and salaried workers. Own-account workers and contributing family workers have less job security because of a lack of contractual arrangements. They also lack the degree of social protection and social safety nets of wage and salaried workers and are therefore not likely to benefit from social security, health or unemployment coverage (ILO, 2013b). The proportion of vulnerable jobs remains alarmingly high in less developed countries, especially in South Asia and Sub-Saharan Africa (ILO, 2010). The agriculture sector continues to offer the worst job conditions and pay, even for salaried workers, most of whom are employed under precarious contract arrangements, working long hours at some times during the year, and earning very little at other times. They also tend to have poor coverage against loss of employment or health, and disability.

The working poor

Holding a job is a means to escape poverty, but in some cases it is not enough; in-work poverty affects 8% of the working-age population – mainly single parents – in OECD countries. Employment remains a strong antidote for poverty in OECD countries, although in-work poverty persists. The poverty rate among jobless households is 5 times higher than that of households where at least one person works. Nevertheless, in-work poverty remains a problem in the OECD, with sizeable cross-country differences. The rate is higher than 12% in Chile, Israel, Japan, Mexico, Turkey, and United States (Figure 2.17). Over the past two decades, in-work poverty has intensified the most for single parents and one-income couples with children, with an average poverty rate over the OECD countries of 22.7% and 18.5% respectively in 2010.

Figure 2.16. **Job strain has increased in all European OECD countries, especially among workers in low-skilled occupations**

Average workers (first panel) and by occupational category (second panel)

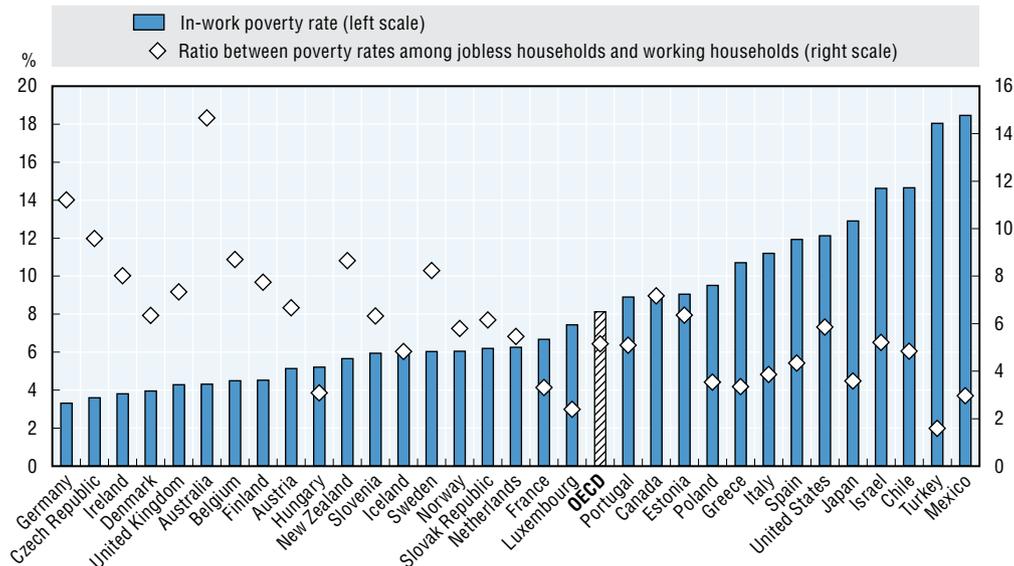


Source: OECD (2012), *Sick on the Job?: Myths and Realities about Mental Health and Work*, Mental Health and Work, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264124523-en>.

Despite strong growth, labour informality is widespread in developing countries and emerging market economies. This is particularly the case in Sub-Saharan Africa, where on average 7 out of 10 individuals in the non-agricultural sector are informal workers (AfDB, 2012). Among OECD countries, informal employment is most widespread in Mexico and Turkey, where 40-60% of the workforce is employed without social security coverage or runs its own business (OECD, 2008b). Although the informal sector acts as a safety valve in countries where the formal sector is narrow, labour informality can exacerbate inequalities. It excludes workers from formal social protection schemes and puts them at a social disadvantage, in particular those who hold 3D jobs (dirty, dangerous and demeaning) (OECD, 2009a). Informal workers are also exposed to a lack of access to financial services and job training, which perpetuates the vicious circle of low productivity jobs and poverty.

Figure 2.17. **In-work poverty persists in many OECD countries**

Incidence of in-work poverty, 2010



Notes:

i) Definition of poverty rates: percentage of individual living in households whose disposable income falls under half the median value of disposable incomes in their country. Poverty rates are calculated for all persons living in a household with a working-age head and at least one worker (in-work poverty rate), and for all persons living in a household with a working-age head and no workers (poverty rate among jobless households).

ii) Poverty rates refer to 2009 for Chile, Hungary, Ireland, Japan, and Turkey.

iii) OECD unweighted average.

Source: OECD Income Distribution Database.

2.6. Education and skills

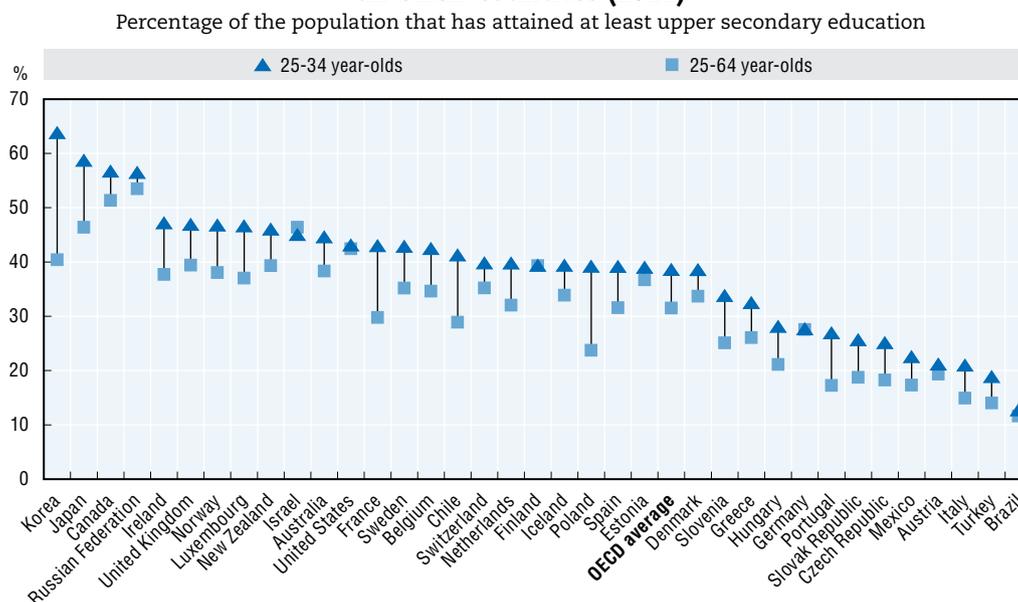
The great educational improvement worldwide

There has been significant improvement in adult literacy, school enrolment and educational attainment worldwide. The adult literacy rate is expected to reach 86% by 2015 (UNESCO-UIS, 2013a), although progress is uneven across countries. From 1990-2000 the literacy rate increased by 22% in Arab states, 16% in South and West Asia and only 6% in Sub-Saharan Africa, from a baseline of about 50% literacy in each region. In developing countries, people had on average nearly two years more education in 2010 than in 1990 and the number of out-of-school children of primary school age fell from 108 million in 1999 to 61 million in 2010. However, progress has slowed worldwide, and on current trends the Millennium Development Goal (MDG) target of universal primary education by 2015 will be missed (UNESCO, 2012a). One third of the world's out-of-school children live in just four countries: Ethiopia, India, Nigeria and Pakistan. In addition, even if female enrolment rates have improved at all education levels, girls remain disadvantaged, in particular, in Southern Asia and Sub-Saharan Africa.⁸ By contrast, in OECD countries, where school enrolment is universal, educational attainment has risen significantly, and on average 75% of 25-64 year-olds have reached upper-secondary education (Figure 2.18) (OECD, 2013b).

Educational outcomes have also improved globally but again with great differences among countries.⁹ Results from the latest OECD Programme for International Student Assessment (PISA) shows that in mathematics, over 245 points, equivalent to almost

six years of schooling, separate the highest and lowest average performance by country. Differences in performance are generally even greater within countries, with over 300 points often separating the highest and lowest performers in a country. Students from the lower quarter on the index of economic, social and cultural status (ESCS) show significantly lower levels of achievement than students at the top quarter of the index.¹⁰ Across the OECD, there is a 90 point difference in average mathematics scores between two ends of the spectrum (OECD, 2013i). In general, the capacity of a country to decrease the gap between socially disadvantaged and advantaged students greatly influences their overall educational performance. The study also reveals that developing countries are increasingly focusing on the quality of learning outcomes. Brazil's progress places it among the PISA countries that have shown the most significant improvements.

Figure 2.18. **Upper secondary attainment is now the norm across almost all OECD countries (2011)**



Note: Excluding ISCED 3C short programmes. Countries are ranked in descending order of the percentage of 25-34 year-olds who have attained at least upper secondary education.

Source: OECD (2013b), *Education at a Glance 2013: OECD Indicators*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/eag-2013-en>.

Unequal access, unequal educational attainment and skills

Unequal access to education remains an issue in developing countries, especially among children from disadvantaged socioeconomic backgrounds. Financial constraints (e.g. foregone salary or labour, school uniforms, textbooks and consumables) create barriers to participation. The same can be said of inadequate infrastructure, such as a lack of clean water and sanitation, which often results in high dropout rates among the poorest and most marginalised children. The quality of schooling, teacher shortages, teacher absenteeism, and the ability to travel safely to and from school also impact on dropout rates. At the secondary education level, there remain barriers to enrolment, as many schools are located in urban areas, making it impossible for poor children, especially girls, dwelling in rural areas to attend given the costs of transport. Overall, disparities in access to education persist regionally within countries, driven by factors

such as wealth, location and gender (UNESCO, 2012b). In Latin America, more than 70% of the children whose parents are tertiary educated also complete tertiary studies, but only 3.1% of the children with parents who did not complete primary education attain this level (OECD, 2012f).

In OECD countries, the expansion of educational opportunities has not necessarily delivered higher educational outcomes and better skills to all. Rather, socio-economic status strongly affects a student's opportunities for upward educational mobility. In Italy, Portugal, Turkey and the United States, more than 40% of young people from low educational backgrounds have not completed upper-secondary education, and less than 20% have enrolled in tertiary education. In contrast, the probability a youth from a low educated background will complete tertiary education exceeds 25% in Canada, Denmark, Finland, France, the Netherlands and Sweden, and is greater than 30% in Australia and Ireland.

The skills distribution among the adult population is also heavily determined by socio-economic background. The 2013 OECD *Survey of Adult Skills* (PIAAC) shows that parental levels of education, a strong measure of socio-economic background, influence literacy proficiency scores in all countries (Figure 2.19) (OECD, 2013g).¹¹ On average across countries, adults with tertiary-level qualifications have a 36 score-point advantage in literacy – the equivalent of five years of formal schooling – over adults who have completed less-than-upper secondary education, after other characteristics have been taken into account. The combination of poor initial education and lack of opportunities to further improve proficiency has the potential to evolve into a vicious cycle in which poor proficiency leads to fewer opportunities to further develop proficiency, and vice versa. Similarly, the PISA results show that there are large differences on numeracy scores within countries, again with students from disadvantaged socio-economic backgrounds registering significantly lower scores than the average. The Survey also shows that immigrants with a foreign-language background have significantly lower proficiency in literacy, numeracy and problem solving in technology-rich environments than native-born adults.

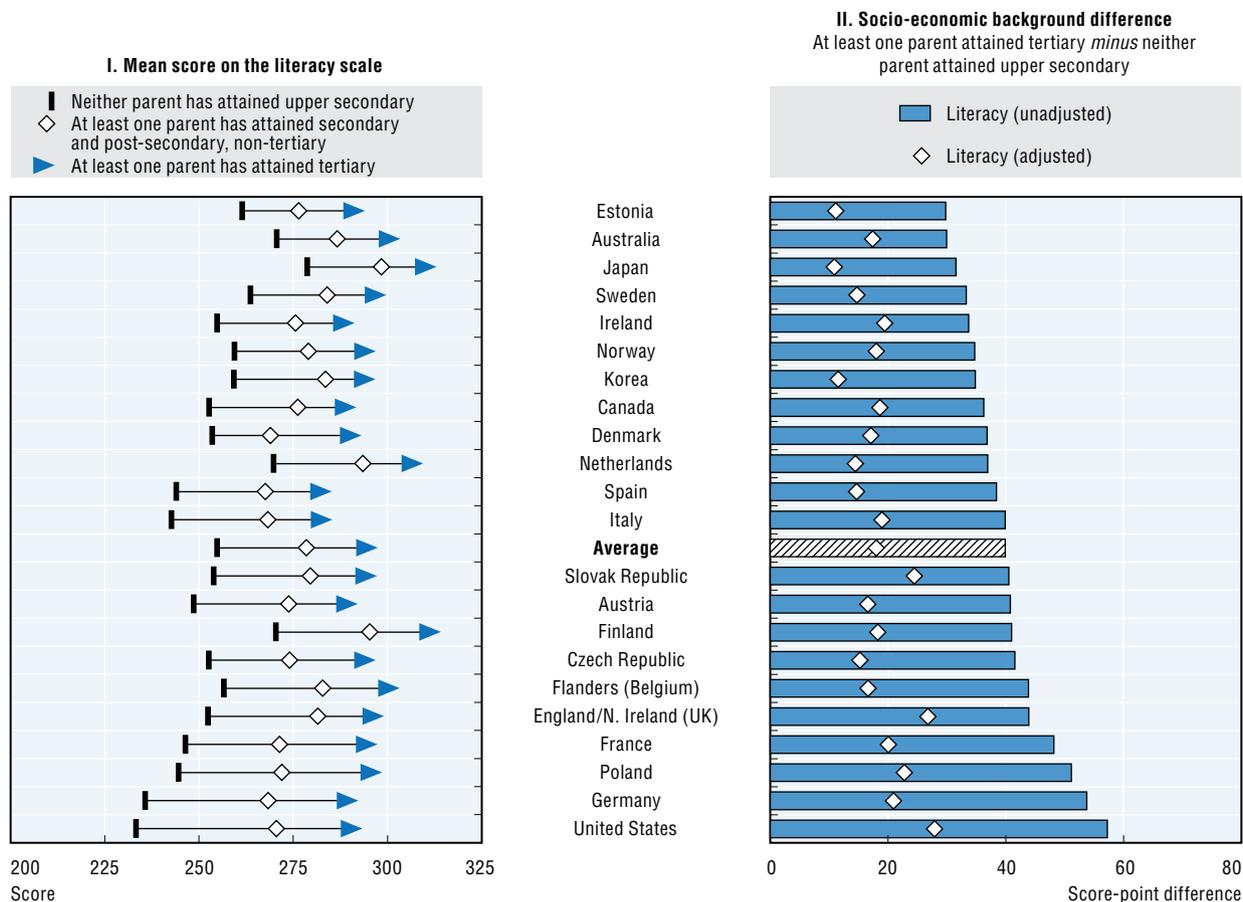
From input to output: Learning outcomes and skills

It is possible to combine high level of performance with equity in education (Figure 2.20). On the basis of the PISA test scores, several countries, including Australia, Canada, Finland, Japan, Korea, Hong Kong-China and Macao-China simultaneously display high student performance in mathematics and a below-average impact of economic, social and cultural status on student performance. By contrast, those countries where poor performance is combined with inequality in outcomes face the challenge of raising the average performance and providing more equal educational opportunities for disadvantaged students. Although immigrant students tend to be socio-economically disadvantaged and thus lower-performing than non-immigrant students, the concentration of immigrant students in a school is not, in itself, associated with poor performance (OECD, 2013j).

Although skills are a powerful determinant of employability, there is often a mismatch between the qualifications of workers and the demands of employers. Mismatches between supply and demand of specific qualifications exist in most advanced economies (OECD, 2013g). Student choices are made on the basis of many different considerations; labour

market prospects and needs compete with personal interests and social stereotypes. For example, most developed economies face shortages in the STEM disciplines (science, technology, engineering and mathematics) and many countries take initiatives to stimulate young people – especially girls and young women – to study STEM subjects. The OECD Survey of Adult Skills (PIAAC) also points to the existence of significant mismatches between skills and their use at work, particularly for some socio-demographic groups. Skills-use indicators show that it is not uncommon that more proficient workers use their skills at work less intensively than less proficient workers do. Data show that over-qualification is particularly common among foreign-born workers and those employed in small establishments, in part-time jobs or on fixed-term contracts. Over-qualification has a significant impact on wages, even after adjusting for proficiency. It also implies a “waste” of human capital, since over-qualified workers tend to under-use their skills. However, part of this type of mismatch is due to the fact that some workers have lower skills proficiency than would be expected at their qualification level, either because they performed poorly in initial education or because their skills have depreciated over time. By contrast, under-qualified workers are likely to have the skills required at work, but not the qualifications to show for them. Mismatches in skills proficiency have a weaker impact on wages than qualification mismatch.

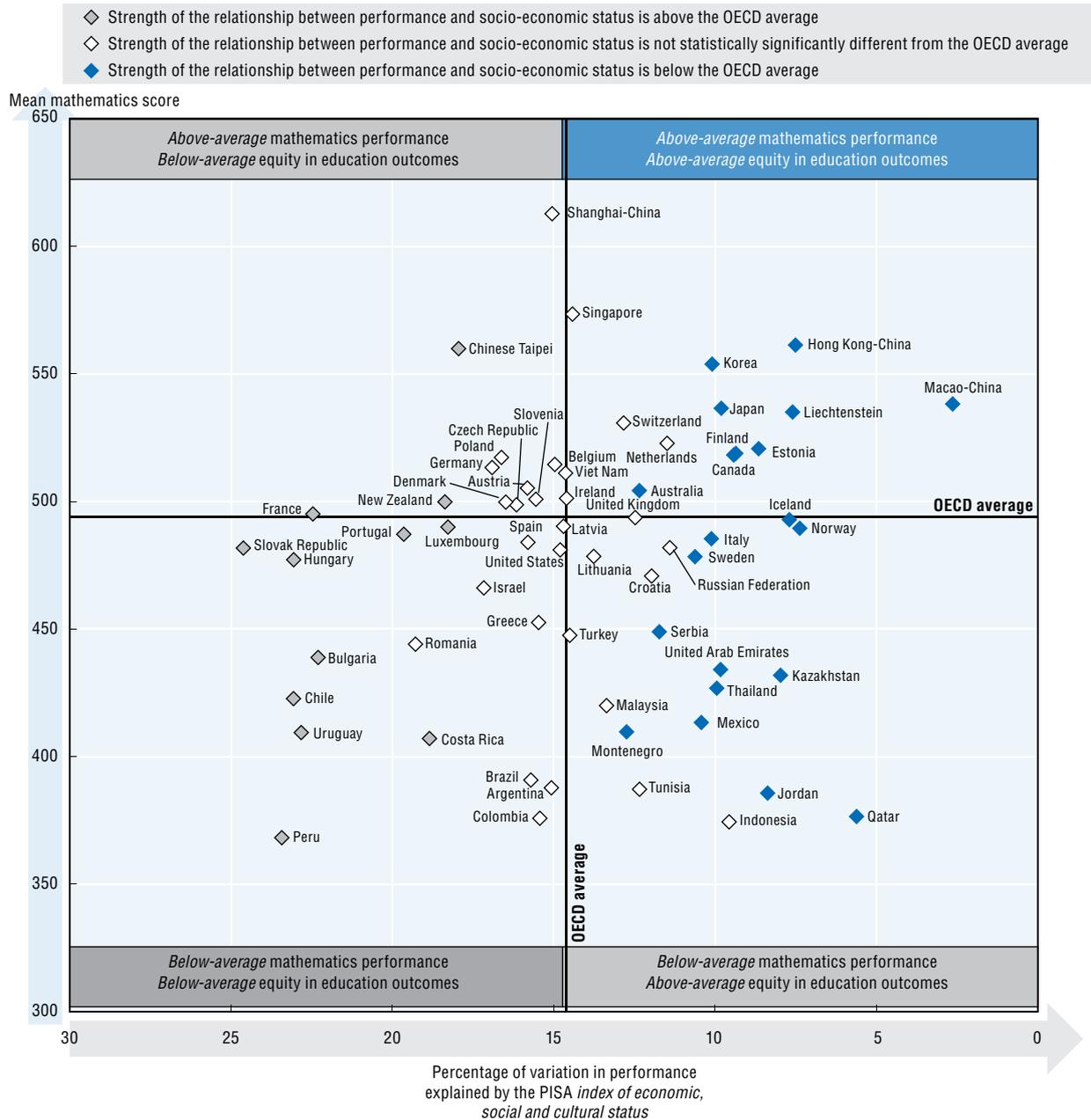
Figure 2.19. **Adults’ socio-economic background matters for their literacy proficiency**



Source: OECD Skills Outlook 2013: First Results from the Survey of Adult Skills, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264204256-en>.

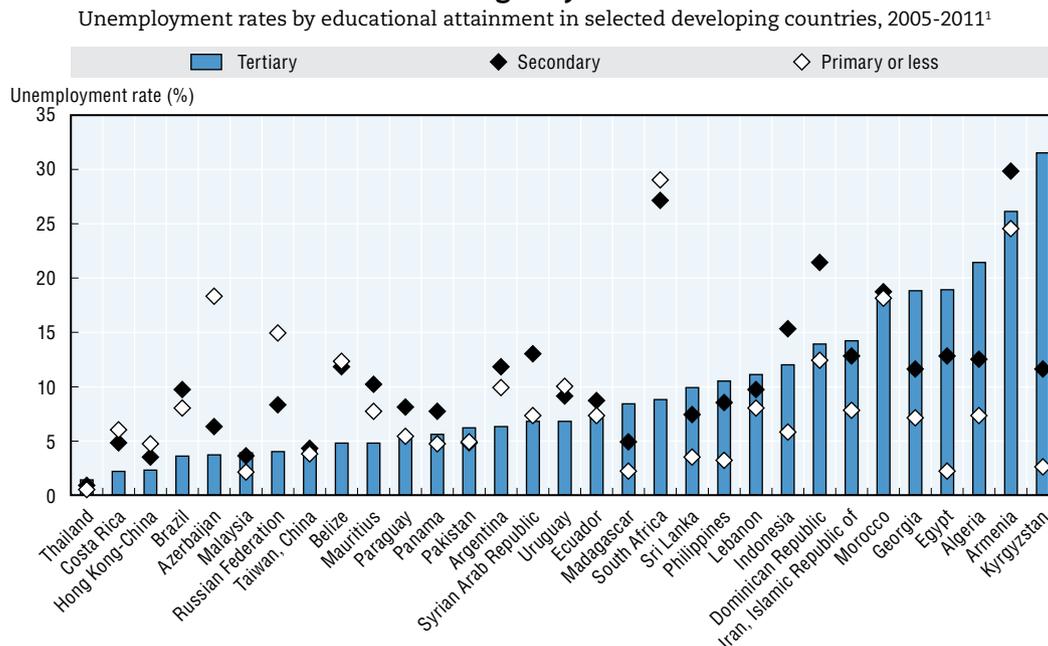
In many developing countries, skills mismatch is a serious concern as joblessness is more widespread among the highly educated than among individuals with primary levels of education or less (ILO, 2012b) (Figure 2.21). In the MENA countries, a significantly higher number of tertiary-level graduates have careers in the social sciences, humanities or law, than in technology or science.¹² According to recruitment and temporary work agencies in these countries, there is a lack of tertiary-level graduates qualified for technical fields, such as the extractive industries, logistics, the chemical and pharmaceutical industries, manufacturing and agri-business (AfDB, 2012).

Figure 2.20. **It is possible to combine high performance with greater equity**



Source: OECD (2013), PISA 2012 Results: Excellence through Equity (Volume II): Giving Every Student the Chance to Succeed, PISA, OECD Publishing, <http://dx.doi.org/10.1787/9789264201132-en>.

Figure 2.21. **In some developing countries a tertiary degree may be too much to get a job**



1. Unemployment rate is computed over the adult population. The definition of adult population is usually 15+ but may differ across countries. The educational categories are conceptually based on the levels of the International Standard Classification of Education (ISCED).

Source: ILO (2012b), "Key Indicators of the Labour Market", 7th Edition, KILM, ILO, Geneva, www.kilm ilo.org.

2.7. Rich and healthy: The link between inequalities in income and health status

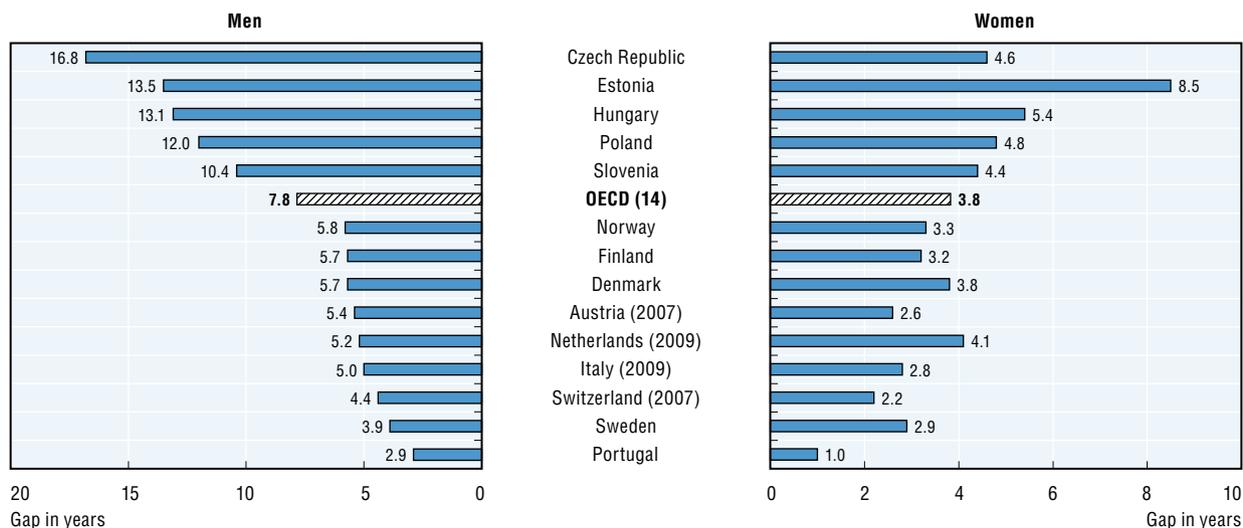
There have been huge gains in life expectancy worldwide, but large disparities remain among socio-economic groups. Improvement in living conditions, a reduction of certain risk factors and progress in health care are the main factors that explain increased longevity. For the first time in history, in 2011, the average life expectancy across OECD countries exceeded 80 years – an increase of ten years since 1970. Life expectancy has also increased over the past decades in many emerging market economies and developing countries, but it still lags behind current OECD levels. In 2011, the average life expectancy at birth in low-income countries was 60 years, 20 years less than the average in OECD countries.¹³ In addition, everywhere, the richest and the most educated are in better health: at age 30, people with the highest level of education could expect to live six years longer than people with the lowest level of education (53 years versus 47 years) (Figure 2.22). Differences in life expectancy by education level are particularly large in Central European countries, especially among men.

In many OECD countries, large inequalities remain in self-rated health status across different socio-economic groups (Figure 2.23).¹⁴ These inequalities reflect differences in living and working conditions, as well as in behavioural factors (e.g. smoking, use of alcohol, physical inactivity, and obesity). Poorly educated women are two to three times more likely to be overweight and obese than those with high levels of education. People in low-income households may also have more limited access to certain health services or use these services less for financial or non-financial reasons, notably certain preventive

services (OECD, 2013c). Greater emphasis on public health and disease prevention especially among disadvantaged groups, and improving access to health services and the quality of health care, can contribute to the further improvements in population health status and life expectancy.

Figure 2.22. **In a number of OECD countries those with the best education live longer: Gap in life expectancy at age 30 by education level**

2010 (or latest year)

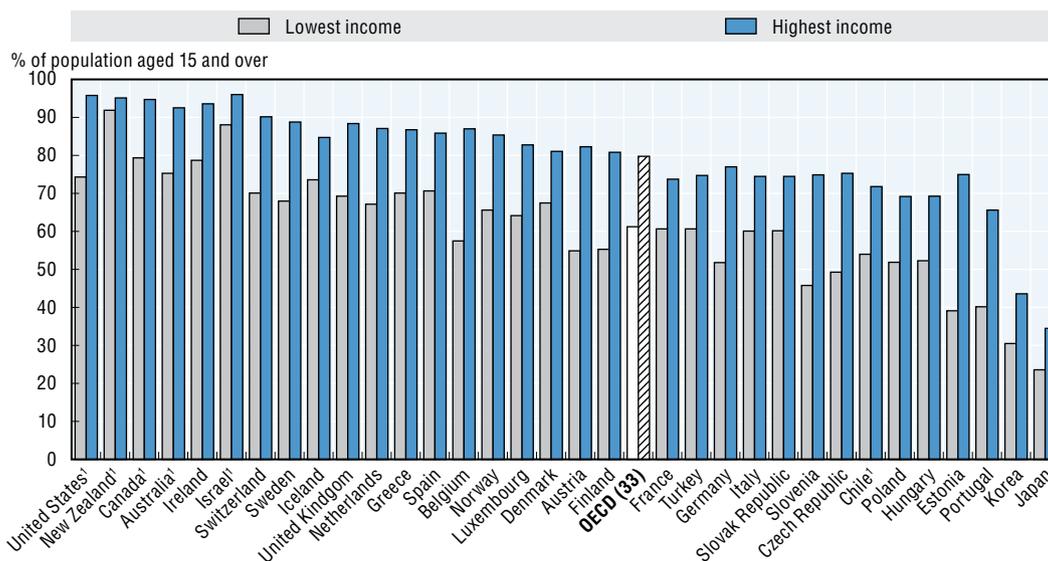


Note: The figures show the gap in the expected years of life remaining at age 30 between adults with the highest level (“tertiary education”) and the lowest level (“below upper secondary education”) of education.

Source: Eurostat database complemented with national data from Austria, Netherlands and Switzerland.

Figure 2.23. **People with higher income report being in better health than those with lower income**

2011 (or nearest year)



Note: Countries are ranked in descending order of perceived health status for the whole population.

1. Results for these countries are not directly comparable with those for other countries, due to methodological differences in the survey questionnaire resulting in an upward bias.

Source: OECD Health Statistics 2013 (EU-SILC for European countries).

Access to health care varies considerably among social groups, especially in developing and emerging market economies, but also in some OECD countries (Box 2.4). In general, access to health services continues to be out of reach to much of the low-income population in developing countries, either for financial reasons or because it is simply unavailable. Women still often give birth without the aid of a trained midwife, nurse, doctor or other skilled birth attendant (Bhutta et al., 2010), and coverage rates of births attended by skilled health personnel are substantially higher among women and children in better-off families

Box 2.4. Increasing universal and equitable access to healthcare

Equity in health care access supposes that people in equal need of healthcare should be treated equally regardless of their income, race, place of residence, occupation or educational level. The ideal is universal health coverage (UHC) which most OECD countries have achieved (Mexico and the US are the major exceptions). Nevertheless, most OECD countries show income-related inequities in the use of various health care services (Devaux and de Looper, 2012). Typically, lower-income people are less likely to visit doctors, especially specialists. Moreover, the proportion of unmet care needs is consistently higher in low-income groups than in high-income groups in OECD countries, with the reason mostly being reported as down to financial barriers. Similarly, differences in life expectancy between the high and low educated at age 30 vary in the OECD area from 2.5 years among women in Slovenia to 17 years among men in Estonia.

Recently, some emerging market economies (China, India, Indonesia, South Africa) have committed themselves to providing UHC for their populations. Some of the key lessons based on OECD country experiences and on-going OECD work with emerging economies to support them in progressing towards UHC, are as follows:

- It is more equitable (and more practical) to have full financial protection for a few of the most important and high-value-added services (e.g. vaccination, minor surgeries and care in the community) for everyone, and then to expand the range of health goods and services over time.
- Paying doctors and hospitals in the right way is more important than the decision about whether to have tax-based, social insurance or private finance for the system.
- Sequencing is important. Primary care and preventive interventions offer more health for the money.
- Using the private sector is often desirable where health care supply is scarce. In an environment of poor supply of health care, any possible source of health service provision should be considered.

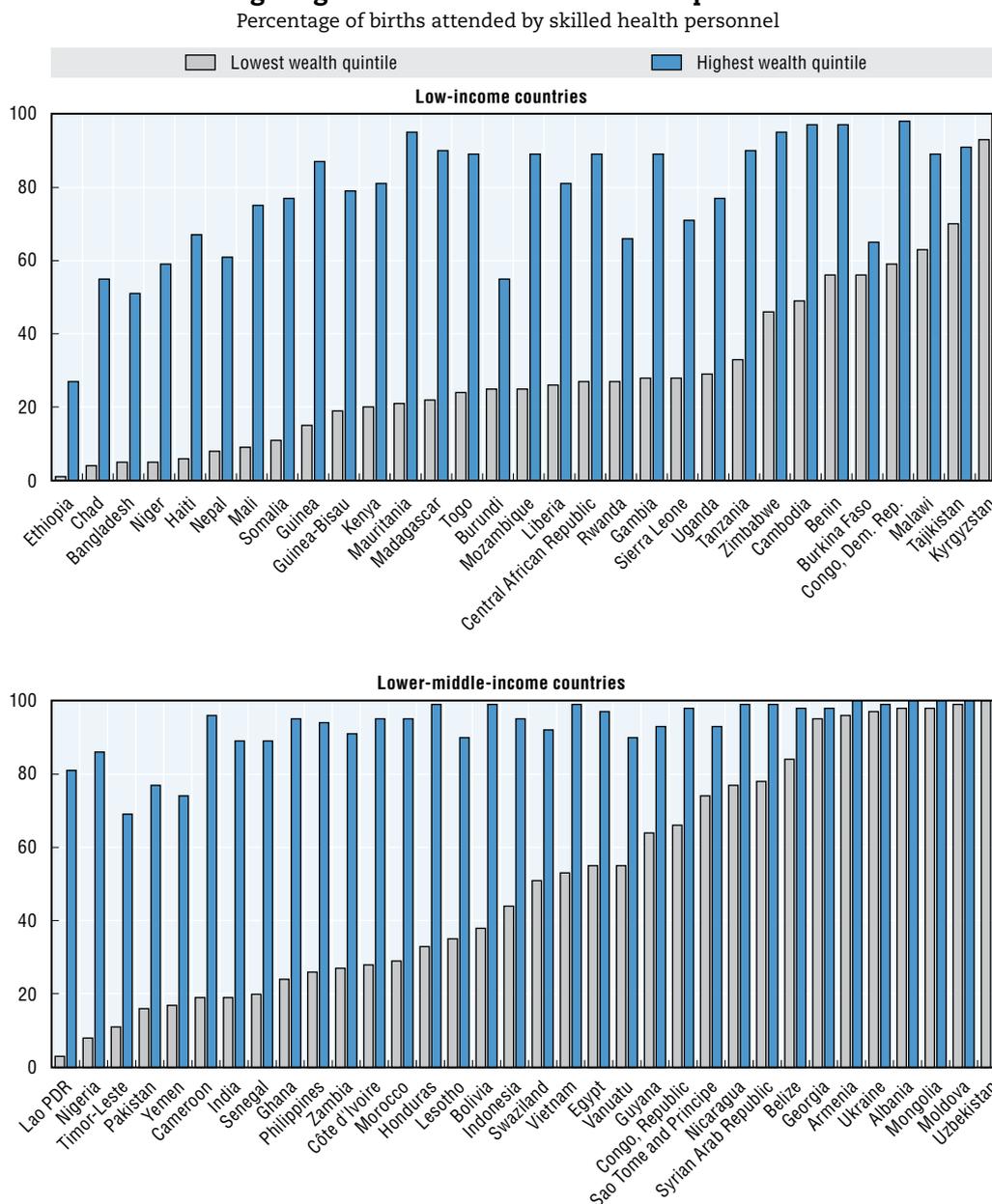
Extending health coverage to more people and promoting equal access to healthcare by reducing barriers, especially financial costs, to seeking care are the main means through which health policies can promote Inclusive Growth. Prevention policies can be especially cost-effective ways to improve population health and reduce health inequality, and to achieve broader social welfare. Policies designed to tackle key behavioural risk factors for health, such as tobacco and alcohol use, unhealthy diets, physical inactivity, obesity, as well as chronic diseases such as diabetes, cardiovascular disease, cancer, chronic respiratory diseases, liver disease and mental health conditions, have the potential to increase employment and productivity, and to reduce social disparities in health.

These policy interventions, which are more cost effective than treating diseases when they emerge, include health education and promotion strategies; fiscal measures that increase the price of unhealthy food or reduce the cost of healthy foods; regulatory measures that inform on nutritional food content or restrict the marketing of unhealthy foods to children; and individual approaches such as physician and dietician counselling for high-risk people. For low- and middle-income countries, the OECD estimated that a package of prevention measures implemented in Brazil, China, India, Russia and South Africa would deliver substantial health gains, with a very favourable cost-effectiveness profile (Cecchini et al., 2010).

Source: Cecchini, M. et al. (2010), "Tackling of unhealthy diets, physical inactivity, and obesity: Health effects and cost-effectiveness", *The Lancet*, Vol. 376, No. 9754, pp. 1775-84; and Devaux, M. and M. de Looper (2012), "Income-related inequalities in health service utilisation in 19 OECD Countries, 2008-2009", *OECD Health Working Papers*, No. 58, OECD Publishing, Paris.

than in poor families (Figure 2.24). In many cases, the poor pay out of pocket for health services due to a lack of insurance coverage, which puts them at a further disadvantage. By contrast, in most OECD countries the health needs of a majority of the population are met, but low-income individuals may face difficulties accessing some health services (OECD, 2013c). A survey, conducted in 2013 in 11 European and non-European countries, shows that low-income individuals are more likely to report unmet health care needs than people on high incomes (Figure 2.25). In the United States, nearly half of adults with below average income reported having some type of unmet health care need due to cost in 2013 (Commonwealth Fund, 2013).

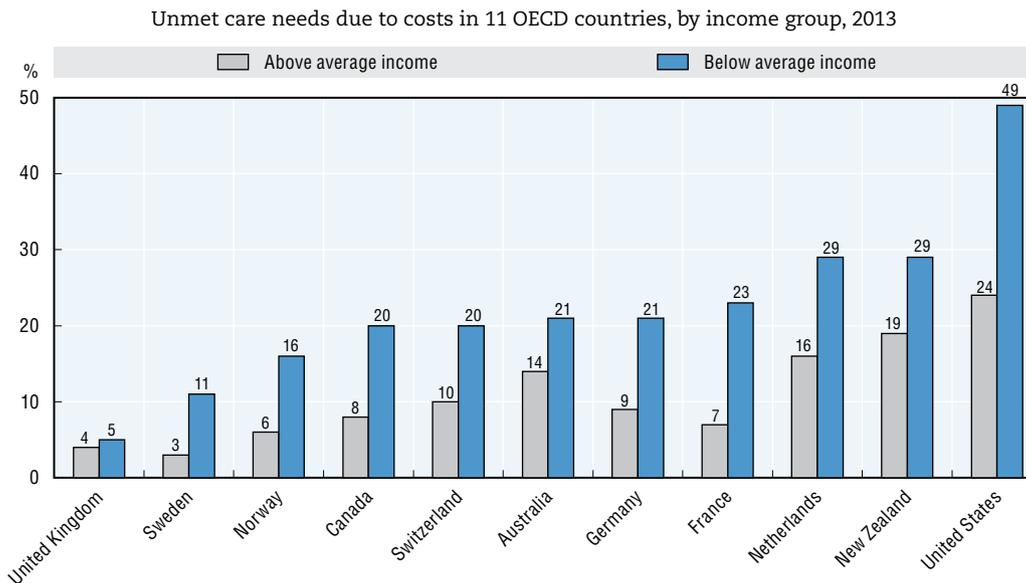
Figure 2.24. **Most women from low-income groups in developing countries are still giving birth without skilled health personnel**



Note: Data available from 2000-2010. Low-income economies (USD 1 025 or less), lower-middle-income economies (USD 1 026 to USD 4 035).

Source: OECD based on WHO Database.

Figure 2.25. **People with low income are more likely to report unmet health care needs**



Note: Unmet health care needs are defined as people who report that they did not visit a doctor when they had a medical problem, did not get recommended care, or did not fill prescription/skipped dose because of cost in the past year.

Source: Commonwealth Fund (2013), 2013 Commonwealth Fund International Health Policy Survey.

There is a link between labour market and health status, resulting in a vicious circle of inequality in income and health outcomes. Despite significant efforts to provide universal basic health care, in many countries entitlements often depend on the labour market status of individuals, putting informal-sector workers at a disadvantage. In East Asian countries, for example, informal workers are often left without any type of health insurance. Considerable progress has been made in many countries in Latin America, but the region still lags behind OECD standards in many areas, and health disparities continue to be strongly dependent on socio-economic status. For example, the proportion of stunted children under 5 years of age is 45% in Peru's poorest quintile, compared to 5% in the richest, and 23% in Brazil compared to 2% in the richest quintile (Althabe et al., 2007). Many countries also confront the issue of the "missing middle": in Viet Nam, for instance, 64% of the total population was covered by health insurance in 2011, including 75% of the salaried workers and 92% of the poorest. However, only 25% of the "near-poor" population, those who recently moved above the poverty line, were covered (OECD, 2014d). The quality of care also correlates strongly with income, in part because of out-of-pocket expenditures and the cost of more comprehensive insurance packages, which puts the poor at a disadvantage.

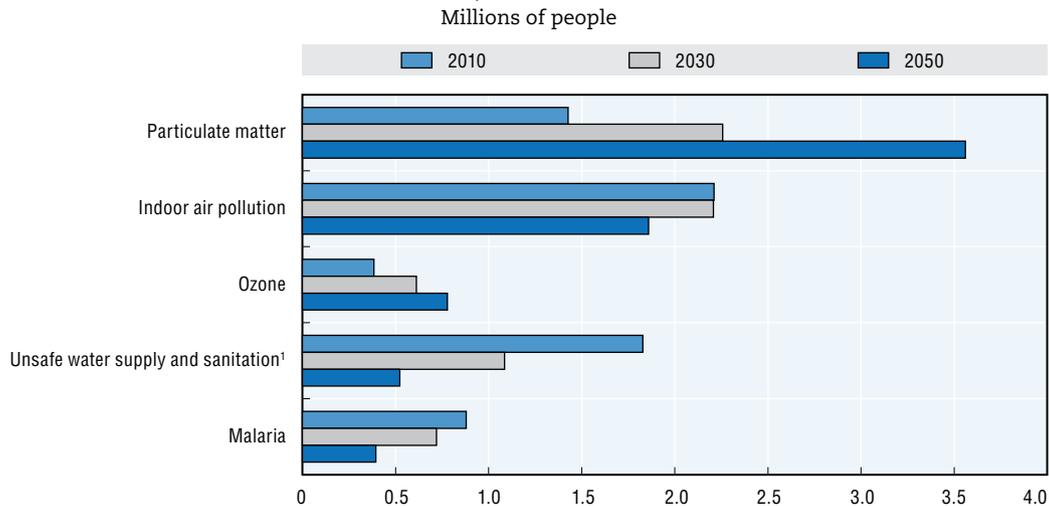
2.8. The environment-inequality nexus: Who is at a disadvantage?

Impact of environmental conditions on health

Environmental conditions have improved overall, but remain worse for poorer individuals and children, affecting their health and earnings capacity. Worldwide, around one-quarter of diseases and overall deaths are due to poor environmental conditions

(Prüss-Üstün and Corvalán, 2006), such as air and water pollution, exposure to hazardous substances and noise (Figure 2.26). While access to sanitation facilities is less of a challenge for OECD countries, much progress is needed in developing countries, where 2.6 billion people still do not have improved sanitation, and 884 million people do not have access to improved sources of drinking water (WHO and UNICEF, 2010). Furthermore, even access to an “improved” water source does not necessarily mean access to “safe” water that is fit for human consumption. Indeed, half of Africa’s hospital beds are filled with people suffering from a water-related disease (OECD, 2012b). There are also indirect effects from climate change, transformations in the water cycles, biodiversity loss and natural disasters that affect the health of ecosystems and damage personal property and livelihoods. Environmental pollution leads to lost worker productivity due to illness and to increased costs of health care. The health effects on children, who are particularly vulnerable, could affect future labour productivity. For example, adults may acquire chronic respiratory illnesses after childhood exposure to air pollution.

Figure 2.26. **Projections of premature deaths from selected environmental risks in 2010, 2030 and 2050**

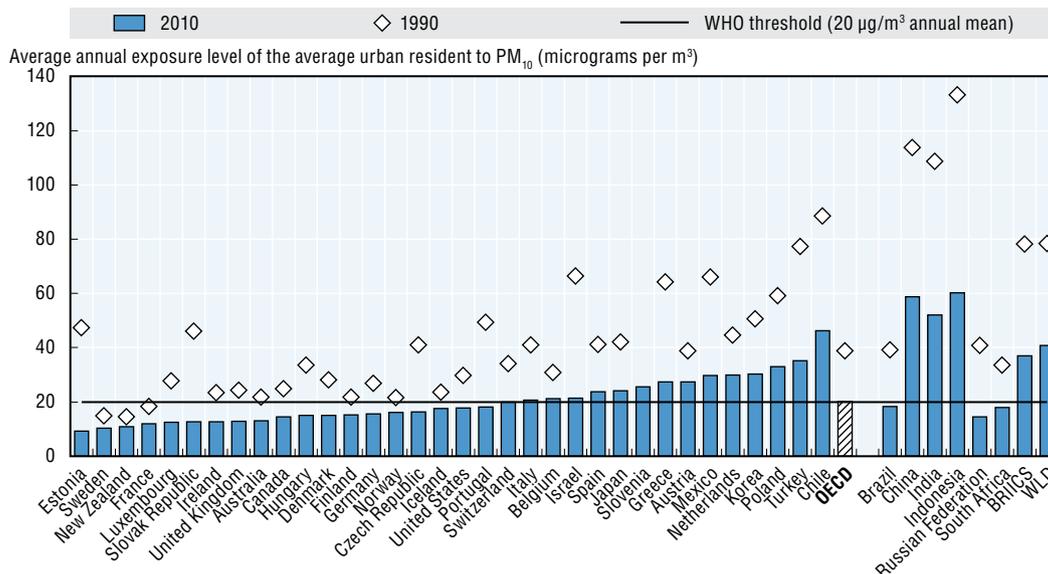


Note: Child mortality only.

Source: OECD (2012d), *OECD Environmental Outlook to 2050: The Consequences of Inaction*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264122246-en>; output from IMAGE.

Despite improvements, air pollution remains at dangerous levels. In the last two decades, concentrations of airborne particulate matter in OECD and emerging countries have dropped significantly, but global levels are still about double the WHO annual limits of 20 micrograms for PM_{10} . Air quality has improved with respect to SO_2 . The share of people living in areas with health-damaging levels of pollution is particularly high in China, India, Indonesia and Chile (Figure 2.27). In the developing world, exposure to pollutants also comes from the indoor combustion of solid fuels in open fires or traditional stoves, and a lack of access to modern energy sources, which increases the risk of mortality among young children and the risk of chronic pulmonary disease and lung cancer among adults (WHO, 2013). The global number of premature deaths linked to outdoor air pollution is expected to rise from about 1.8 million today to around 4.4 million in 2050 due to exposure to both ozone and particulate matter (PM) (OECD, 2012d).

Figure 2.27. **Population exposed to air pollution by small particulates (PM₁₀) decreased in OECD and BRICS countries over 1990-2009 but levels remain above WHO thresholds in several countries**



Source: World Bank, World Development Indicators, <http://data.worldbank.org/indicator/EN.ATM.PM10.MC.M3>.

Challenge of access to water supply and sanitation

Access to basic environmental services remains a major issue in emerging economies and developing countries (Figure 2.28). While access to sanitation facilities is less of a challenge for OECD countries, much progress is needed to help emerging countries such as India, Indonesia and China (Figure 2.29). Poor water supply and hygiene practices lead to 1.9 million deaths every year from diarrheal diseases, 90% of whom are children under the age of five.¹⁵ Despite strong calls for action at the international level, the Joint Monitoring Program, led by the World Health Organisation (WHO) and UNICEF, found that 2.6 billion people still do not use improved sanitation, whilst 884 million people do not use improved sources of drinking water (WHO and UNICEF, 2010). Furthermore, even access to an “improved” water source does not necessarily mean access to “safe” water that is fit for human consumption.

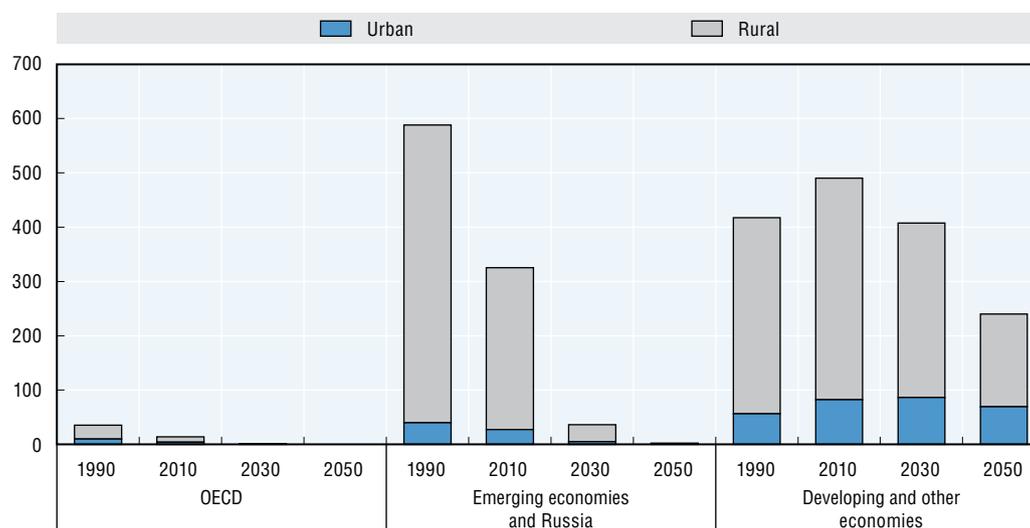
Who suffers the most?

The environmental burden of disease (EBD), a measure of the environmental burden on society, shows high levels of environmental deterioration particularly in the emerging market economies.¹⁶ While the EBD ranges between 13% and 20% in many OECD countries, it reaches higher levels in Eastern Europe, Korea and Turkey, where up to one-third of the disease burden could be prevented through better environmental conditions (e.g. curbing air pollution and providing safe water and sanitation). According to the WHO, 24% of the total burden of disease at the world level, or 13 million premature deaths, could be prevented through environmental improvements (Prüss-Üstün and Corvalán, 2006). Also, the EBD most strongly affects the poorest, the youngest and the oldest populations. In developing countries, the poor typically live in less healthy areas and are more vulnerable to indoor air pollution from solid fuel use, and the communicable diseases associated with poor water and sanitation facilities (e.g. diarrhoea and malaria). In advanced economies, environmental problems tend to affect low-income families and communities as well.

Short-term effects of high PM_{10} concentration appear to be largely restricted to people of low socio-economic status, due to a combination of greater susceptibility and higher exposure (Gwynn and Thurston, 2001). The very young and the very old are more at risk than the remainder of the population to air pollution and other environmental hazards (Pope and Dockery, 1992) (Schwartz, 1994) (Box 2.5).

Figure 2.28. **Access to improved water supply will remain a key challenge for rural citizens in developing countries by 2050**

Millions of people lacking access to improved water supply

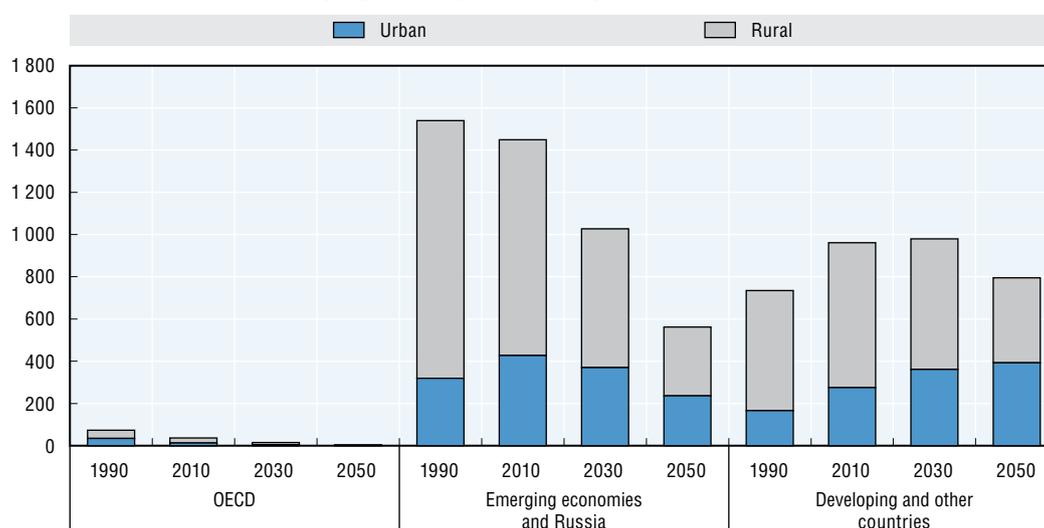


Note: Emerging economies include Brazil, China, India, Indonesia and South Africa. Developing and other economies include all other countries.

Source: OECD (2012d), *OECD Environmental Outlook to 2050: The Consequences of Inaction*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264122246-en>; output from IMAGE.

Figure 2.29. **Access to improved sanitation facilities will remain a major challenge for emerging economies and developing countries by 2050**

Millions of people lacking access to improved sanitation facilities



Note: Emerging economies include Brazil, China, India, Indonesia and South Africa. Developing and other economies include all other countries.

Source: OECD (2012d), *OECD Environmental Outlook to 2050: The Consequences of Inaction*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264122246-en>; output from IMAGE.

Box 2.5. The effects of air pollution on children's health

It has been estimated that 43% of the global environmental burden of disease falls on children under five, and that 80% of the burden of disease for infants and young children has an environmental origin. According to the WHO Task Force on the Protection of Children's Environmental Health, respiratory infections account for 20% of mortality in children under the age of five. Many OECD countries also report asthma epidemics that are aggravated by air pollution. The United States, for example, has approximately 4.8 million school-age children with asthma.

Much of the existing literature regarding environmental effects on human health has focused on adults. Despite a large number of actions undertaken in OECD countries to protect children's health from environmental degradation, most existing legislation does not take into account children's special vulnerability to environmental risks. Early epidemiological evidence suggests that in many cases, children do not have the capacity to metabolise and detoxify toxic compounds the way adults can. During development, children require a high rate of energy consumption, and large amounts of food, air and water intake expose them to more pollution than adults (e.g. when children are exercising during sport events, they may take in 20% to 50% more air, and thus air pollution, than adults in comparable activities). Different behavioural patterns in children may also play a role in their particular vulnerability to environmental health effects. Children spend more time outside than adults, and are often outdoors during times when air pollution is at its highest. Furthermore, children have more time to develop diseases that take years to occur, such as cancer, cardiovascular and neurodegenerative disease. Moreover, children are more susceptible to sustained chemical exposure. When a product appears on the market, children may remain exposed to its chemicals throughout their lives, while adults necessarily live with the chemical exposure for a shorter period.

Sources: OECD (2006b), *Economic Valuation of Environmental Health Risks to Children*, OECD Publishing, Paris and OECD (2008c), *OECD Environmental Outlook to 2030*, OECD Publishing, Paris.

Pollution is worse in urban areas in all countries. In many urban regions in Europe, a large share of population is exposed to elevated values of particulate matter above an annual average concentration of 20 $\mu\text{g}/\text{m}^3$ in 2010 (EEA, 2013), levels that present a high health risk. Ozone pollution affects urban dwellers in OECD countries, but urban dwellers in developing countries also face particular environmental challenges. The share of city dwellers without access to treated water is high and rising in sub-Saharan Africa, where the Millennium Development Goal for improved water supply is unlikely to be met. Fast urbanisation in Africa and Asia has led to higher concentrations of air pollution (Box 2.6). All emerging countries except Brazil and South Africa have particulate matter levels well above the OECD average. Only 2% of the global urban population are currently living below the WHO Air Quality Guideline of 20 $\mu\text{g}/\text{m}^3$, while about 70% of the urban population in the BRIICS and non-OECD member countries are exposed to concentrations above the highest interim standard (above 70 $\mu\text{g}/\text{m}^3$). The *OECD Environmental Outlook to 2050* projects OECD countries as a group to have one of the highest ozone-related mortality rates in terms of number of deaths per million inhabitants – second only after India and higher than China and other emerging economies – due to the much greater ageing of the population (Figure 2.30) (OECD, 2012d).

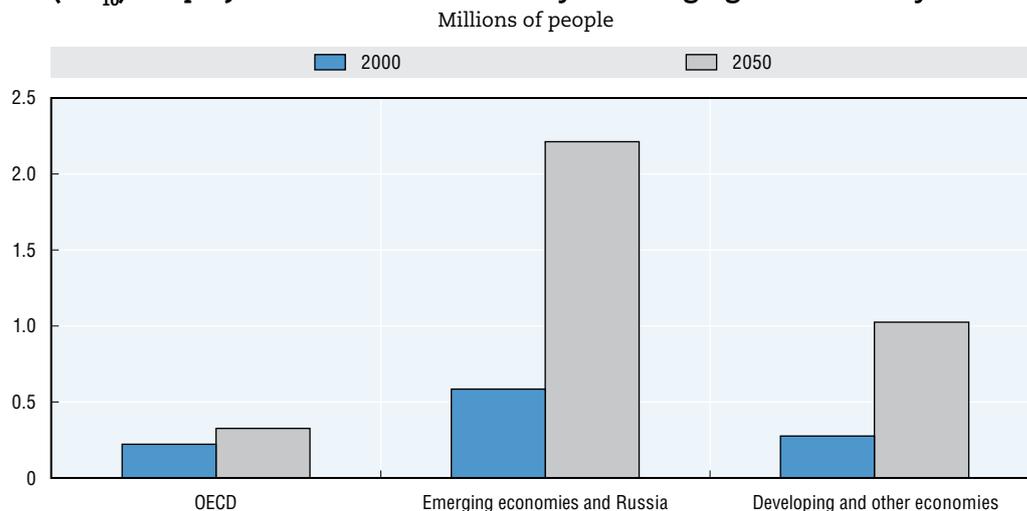
Box 2.6. Drivers of urban pollution

The year 2008 marked the first time in which more than half of the world's population lived in towns and cities. By 2030, it is estimated that this number will swell to almost 5 billion people (UNFPA). Such rapid urbanisation presents challenges that may threaten the environment and quality of life. Outdoor pollution is one of the main problems facing growing cities, and comes from a range of anthropogenic sources:

- **Road transport:** In many countries, air pollution from motor vehicles has replaced coal smoke as the major cause for concern. The growing use of motor vehicles means that efforts to reduce emissions from individual vehicles may be jeopardised by increases in the volume of traffic. In many developing countries, efforts to control pollution are further threatened by the use of old vehicles that do not meet modern pollution control requirements.
- **Power generation:** Generating power produces more pollution (in particular, sulphur dioxide and nitrogen oxides) than any other single industry. Better dispersion of pollutants emitted by tall chimneys brings better dilution in the air and lowers local concentrations of pollutants. This, however, leads to wider dispersion of pollution and to trans-boundary air pollution. Stricter operating practices and the use of modern abatement techniques have resulted in a sizeable reduction in the amount of pollutants emitted from power stations. High concentrations still occur in many developing countries, however, particularly from older power stations and from the use of high sulphur lignite or coal.
- **Waste disposal:** Landfill and incineration are the most common methods of waste disposal. If not properly managed, landfill sites can cause a number of problems, such as the production of methane gas, dangerous levels of carbon dioxide, and trace concentrations of a range of organic gases and vapours. Poorly managed incineration can result in the production of poisonous chemicals such as hydrochloric acid, dioxins, furans and heavy metals. Hydrochloric acid produced by the burning of plastics contributes locally to acid rain. The burning at low temperature of organic matter and plastics can also lead to emissions of dioxins.

Source: Adapted from EEA (2010), *Urban Environment – SOER 2010 Thematic Assessment*, EEA, Copenhagen, Denmark.

Figure 2.30. **Premature deaths in urban areas from exposure to particulate matter (PM₁₀) are projected to rise substantially in emerging economies by 2050**



Note: For urban areas with populations over 100 000. Emerging market economies include Brazil, China, India, Indonesia and South Africa. Developing and other economies include all other countries.

Source: OECD (2012d), *OECD Environmental Outlook to 2050: The Consequences of Inaction*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264122246-en>; output from IMAGE.

2.9. The geography of inequalities

The various dimensions of inclusion and exclusion are unevenly distributed across space – and often mutually reinforcing. Inequalities in income, opportunity and access to essential services all vary substantially within and across OECD countries. Spatial concentration of these forms of disadvantage vary strongly at various territorial scales and these different sources of inequality can reinforce one another, locking households and communities into circumstances that make it particularly hard for them to improve their life chances.

Wealth and poverty are concentrated spatially. Regional inequalities in GDP per capita have increased in many OECD countries since 1995, especially in Eastern European countries, and are particularly high in emerging market economies. In developing countries, income differentials between urban and rural areas are particularly pronounced, and rising inequality in big cities is sometimes the result of increasing inflows of wealthy people rather than growing concentrations of poverty (Glaeser et al., 2008). However, this is far from universal: and for most countries, poverty is higher in regions with lower average levels of income: poverty, like wealth, tends to be spatially concentrated. Relative poverty rates of regions (incomes less than 50% of the national median) provide a picture often masked by country averages. In Mexico, Turkey and Italy, relative poverty rates can vary from 50% (32% in Italy) to less than 7% (Figure 2.31) (OECD, 2014a).

Income inequality is higher within urban areas than elsewhere. In many countries, urban income inequality has been rising faster than overall income inequality. For example, in 2009, 17 of the top 25 US metropolitan areas had estimated Gini coefficients above the US national average (American Community Survey, 2010). In France, the median household income of the top 10% in France was 3.4 times that of the bottom decile, but this ratio varies widely across space, reaching 8.4 in the Aix-Marseille metropolitan region (OECD, 2013).

Large cities tend to be more unequal than smaller ones, and the relationship between city size and intra-urban inequality seems to be strengthening. This is disconcerting when seen against the backdrop of demographic trends towards increasing concentration of populations and activity in larger cities, especially in emerging economies and developing countries. Evidence suggests that it reflects changes in the nature of cities' economic specialisations. Very large cities increasingly concentrate specific managerial and administrative functions and the high-value services that support them (corporate headquarters, R&D, finance, etc.). However, as Sassen (2006) points out, lower-skilled jobs are also increasingly in demand in such cities (i.e. their skill profiles are more polarised). This can be problematic when such low skilled jobs are not able to pay a "living wage".¹⁷ As a result, even the most dynamic metro regions have experienced rising inter-personal inequality (OECD, 2006a).

While urbanisation can help lift people out of poverty, large numbers of urban residents remain trapped in it. Drawn to the cities by the opportunities they offer, many migrants from rural areas struggle with the high costs of living in cities, giving rise to an "urbanisation of poverty" for those who lack the skills required to compete within city labour markets. In most OECD countries, exclusion and poverty have become urban phenomena. These issues are prominent not only in less-advanced metro-regions like Mexico City (about 50% of the population are in relative poverty), partly due to rural migration, but also in cities that have

faced strong industrial restructuring (Rotterdam, Lille, Detroit) as well as in the suburbs of some of the richest metro-regions (Paris, London, New York).

Unequal access to employment contributes to inter-regional inequalities. In the past decade, employment growth in many OECD countries was highly concentrated in specific regions (OECD, 2013f). On average, 40% of overall employment creation in OECD economies during 1999-2012 was generated in just 10% of their regions. With the economic crisis, employment destruction has likewise been highly concentrated. In fact, in Ireland, New Zealand, France, Estonia, the Netherlands, Canada, and the Slovak Republic, half or more of the gap between current and pre-crisis employment levels could be filled if just one region returned its employment rate to its pre-crisis level (OECD, 2013f). In many countries, regional disparities in youth unemployment have grown wider since the crisis. Southern European countries and Mexico are of particular concern, because in some regions the youth unemployment rate now exceeds 40%. Furthermore, while large cities drive national employment in many countries, the economic crisis has affected urban labour market conditions. The unemployment rate in metropolitan areas rose more in the period 2008-12 than it did in the previous 8 years in 26 of the 28 OECD countries. In 2012, 45% of OECD metropolitan areas had an unemployment rate above the national rate (OECD, 2013f).

During 2007-11, the total number of unemployed people in 207 large OECD metros, for which data are available, rose by over 56% (with a peak at over 60% in 2010). Over the same period, total unemployment in the 25 countries where those metros are situated rose by just under 49% (with a 2010 peak 53% above the pre-crisis low of 2007). In 2012, the situation began to reverse, as metropolitan unemployment across the OECD fell, while aggregate unemployment in the countries concerned rose slightly. Nevertheless, the proportion of large OECD metros with unemployment rates above their national averages rose from about 40% in 2007 to 48% in 2011-12. The metros' share of aggregate unemployment rose OECD-wide and in 18 OECD countries, including six of the G7 (France was the exception).

The concentration of unemployment in large cities reflected not only the shocks that hit them but also, in some instances, migration of unemployed workers from elsewhere to the cities in search of jobs. Either way, the fall-out from the crisis was increasingly felt in the big cities. For national economies stagnant metropolitan labour markets are a serious problem, given that large metro areas accounted for over half of all net employment growth in the OECD area since 2000 (OECD, 2013f).¹⁸

At smaller territorial scales, access to employment may be an issue where public transport networks and other infrastructure put households in poorer neighbourhoods at a disadvantage. Extreme examples of such problems may be found in, for example, South Africa, where Apartheid-era patterns of spatial segregation persist and mean that black households are often located far from employment opportunities (OECD, 2011h). Yet even in far wealthier OECD countries, it may be difficult for those from poorer neighbourhoods to commute to where the job opportunities are, owing to expensive and/or fragmented public transport networks (OECD, 2012g and OECD, 2012h).

Countries have large inter-regional differences in educational attainment. In 2012, one quarter of the OECD population had only a basic education (i.e. no more than lower-secondary educational attainment). Such people tend to be concentrated in particular places. For example, in most of the regions in Turkey, Portugal and Mexico, and in some regions in Australia and Spain, the proportion of the population with only a basic education

was as high as 50% (Figure 2.32). Territorial disparities in the share of workers with tertiary education are also important. The United States, Spain, the Czech Republic and Turkey show the largest regional variation in tertiary educational attainments. For countries with less regional dispersion, the greatest issue is often the concentration of the skilled labour force, particularly in and around the capital.

Regional factors strongly affect access to, and returns from, education and quality of learning. Even when taking into account the socio-economic backgrounds of students, the location of schools matters greatly in determining the quality of education. In the OECD area, 15-year-old students in urban schools outperform those in rural areas on the PISA test by more than 20 points on average, which is the equivalent of almost one year of education (OECD, 2013i). Moreover, the evidence suggests that the returns to education in urban areas are higher than they are in less dense places. This differential can be a major incentive for highly educated individuals to migrate to cities.

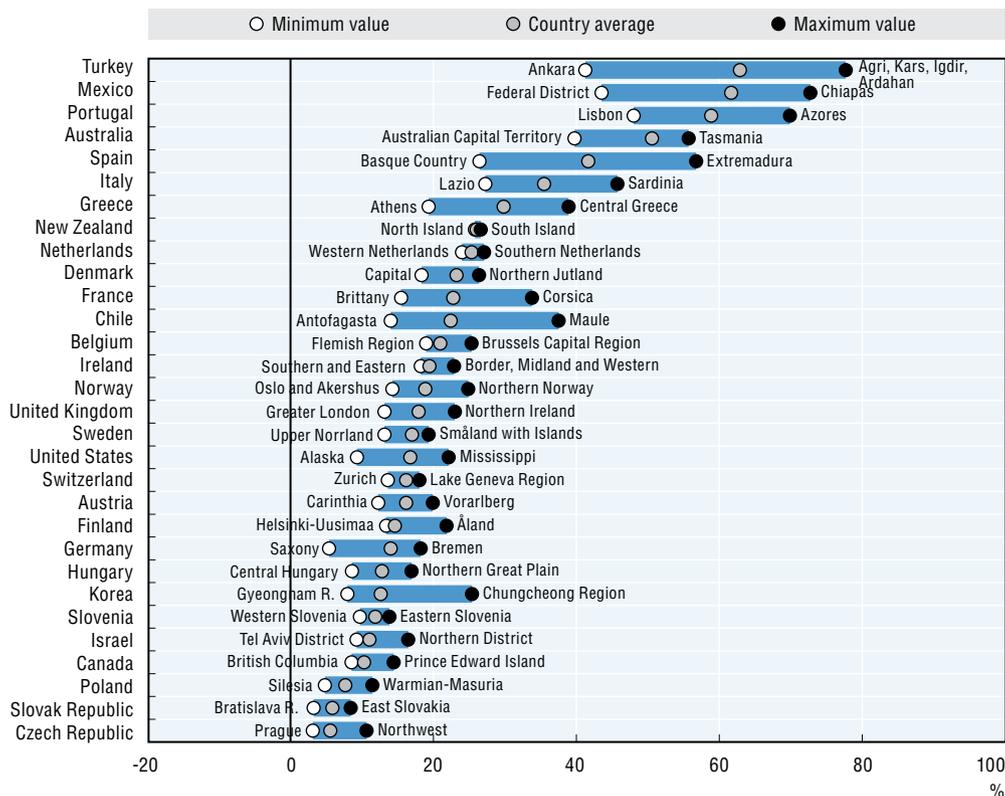
Considerable disparities in education can be found *within* metropolitan regions as well. In the Chicago region, for instance, school districts record high school graduation rates that range from 57% in the city of Chicago to over 95% in suburban areas (OECD, 2012h). In Aix-Marseille, the share of the working-age population without a diploma ranges from 39% in neighbourhoods in northern Marseille to 14% in Aix-en-Provence (OECD, 2013l).

Access to education services in developing countries is increasingly becoming harder in urban areas. In fact, children from poor urban neighbourhoods are less likely to attend school than children from other urban areas and rural areas. A survey in Delhi in 2004-2005 shows a primary school attendance rate of 54.5% among children living in slums, compared to a 90% attendance rate for the city as a whole. Similarly, in Bangladesh, 18% of children attended secondary education in 2009, compared to 53% in urban areas as a whole, and 48% in rural areas (UNICEF, 2012). In several African countries, enrolment improved in the non-slum urban areas in the late 1990s, but worsened in the urban slums.

Inequality in skills is very much pronounced at the metropolitan level. There are more skilled workers in urban areas than in non-urban areas, but larger cities also have greater skill and wage disparity within skill groups than do smaller cities (Baum-Snow, N. and R. Pavan, 2012). Rising inequality also exists within skill groups and job polarisation. One factor in urban disparity is that skill upgrading provides greater returns in larger urban areas than smaller ones. For example, agglomeration economies for skilled and specialised work may increase income inequalities in large cities by favouring highly qualified workers (Belal and Partridge, 2006). There are also substantial differences in the returns to skills in urban areas, related to local concentrations in different industries, and these too are strongly correlated with inequality. Skills inequality results from differences in education, from immigration, from the effect of industry concentrations, and from differences in the returns to skills depending on location (Glaeser et al., 2008). OECD research has also identified regional disparities in the intensity with which skills are utilised by employers; some regions and some cities become trapped in a “low skills equilibrium”, in which the returns to skill are depressed, because local demand for skills is low (Froy et al., 2011, OECD, 2014c).

Figure 2.32. **Some regions in OECD countries can have a proportion of the population with only a basic education as high as 50%**

Regions with the lowest and highest percentage of workforce with only basic education, 2012



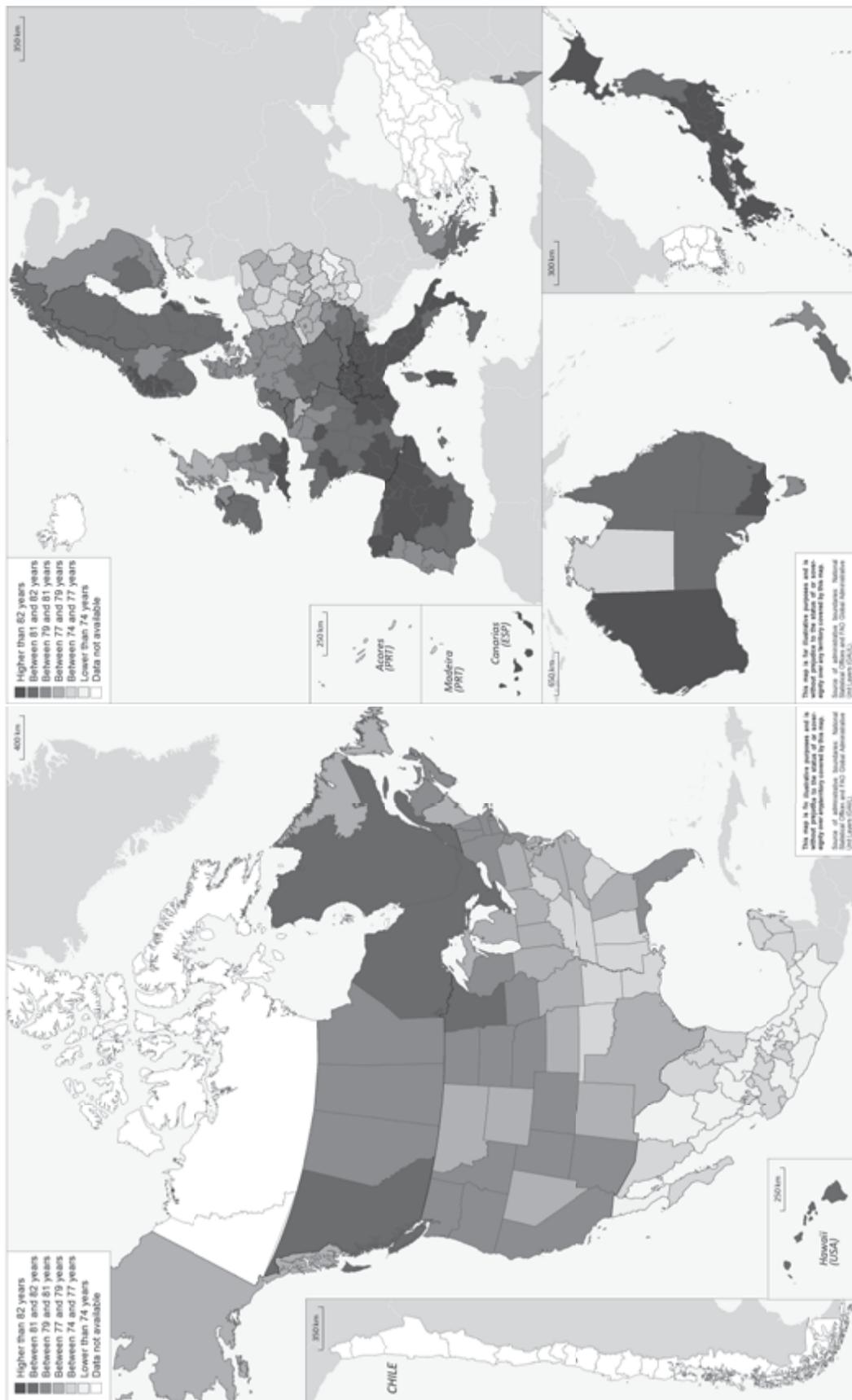
Note: Countries ranked by average share of population with only basic education.

Source: OECD (2013f), *OECD Regions at a Glance 2013*, OECD Publishing, Paris, http://dx.doi.org/10.1787/reg_glance-2013-en.

Significant regional disparities in health outcomes are in part the product of unequal access to health services. In 2010 in North America, the life expectancy at birth in Texas (USA) was around 75 years, which was 6 years lower than in Minnesota (USA) and the life expectancy in Chihuahua (Mexico) was only 68 (Figure 2.33) (OECD, 2013f). There are also large differences in the age-adjusted mortality rates within countries. In most countries, the richest regions tend to have a higher number of doctors and lower age-adjusted mortality rates.

In general, the unequal distribution of resources and health services mainly affects rural areas, but the urban advantage is increasingly challenged. In OECD countries, rural areas are more affected by population ageing, diseconomies of scale in the provision of healthcare services and problems in accessing healthcare facilities. However, the rural disadvantage in access to health services is more pronounced in developing countries. A World Bank report found that urban per capita consumption exceeded rural per capita consumption by more than 40% in 72 developing countries (World Bank, 2009b). Limited access to paediatric healthcare in rural areas affects the poorest rural families. The risk of mortality is lower for children from wealthier families living in urban areas with better-educated mothers. Inequalities in under-age-5 mortality rates between urban and rural areas are particularly high in Cambodia and Albania. Providing equal access to healthcare and improving health conditions for vulnerable groups are also becoming a major concerns

Figure 2.33. Life expectancy depends where you live (2010)



in urban areas, which confront higher income inequality. Although people living in cities have better access to health services than their counterparts in rural areas, the scale of inequality within urban areas can sometimes equal or even exceed that of rural areas (UNICEF, 2012).

Notes

1. The Gini coefficient is a standard measure of inequality, where zero means everybody has the same income and 1 means the richest person has all the income.
2. While in principal corporate income is fully redistributed in the long term, the rise in corporate saving, as well as the treatment of capital gains from re-invested profits, including abroad, may explain part of the discrepancy between growth in GDP and household income (Causa et al., 2014).
3. A non-exhaustive list of papers on the shrinking of the US middle class includes Blackburn and Bloom (1985), Duncan et al. (1991), Levy (1987a and 1987b), Horrigan and Haugen (1988), Bradbury (1986) and Thurow (1984). Recent papers that have covered European countries include Grabka and Frick (2008). Goos and Manning (2007) provides a country perspective on Germany and Pressman (2007) on the UK. Ravallion (2010) focuses on developing countries.
4. Whereas the incidence of poverty is conventionally measured by the headcount of individuals or households with incomes below the poverty line, the depth of poverty can be gauged by the shortfall between the average income of the poor and the poverty line. The poverty gap is calculated as the distance between the poverty threshold and the mean income of the poor, expressed as a percentage of the poverty threshold.
5. Preliminary estimates indicate that the 1990 extreme poverty rate – based on the international poverty line of USD 1.25 a day (in 2005 prices) – was actually halved in 2010 to 1.25 billion (United Nations, 2012a).
6. According to Povcal Net, in 2009 the Chinese population below the absolute poverty line of USD 1.25 was 11.80%. National distribution is based on aggregated Lorenz curve from original rural and urban distribution. Rural and urban distributions must be included when aggregating poverty measures from a group of countries (<http://iresearch.worldbank.org/PovcalNet>).
7. In 2010, labour force participation rate stood at 28% on average in the MENA countries and 44% in Southeast Asia compared to 65% in OECD countries (ILO, 2012a).
8. Yet, if adolescent girls are kept in school to complete a quality secondary education, they will be much better equipped to reach their full potential and make informed choices about their lives. Just one additional year in school gives women better economic prospects, more decision-making autonomy, greater control over their own fertility, healthier children, and better chances of sending their own children to school.
9. The OECD Programme for International Student Achievement (PISA) assessment measures the learning outcomes of 15-year-olds in mathematics, reading and science. The assessment evaluates the quality, equity and efficiency of school systems in over 60 countries that together make up nine tenths of the world economy.
10. The PISA index of economic, social and cultural status (ESCS) is a composite index derived from three indices: highest occupational status of parents, highest educational level of parents, and home possessions (including for example numbers of books in the home).
11. PIAAC measures proficiency in literacy, numeracy and problem solving in technology-rich environments among 16-65 year-old adults in 24 countries and sub-national regions.
12. For example, in 2010, 41% of the Algerian tertiary graduates studies social sciences, business and law, and 19% humanities and arts, while 14% of them studies science and 13.8% engineering, manufacturing and construction (UNESCO-UIS, 2013a).
13. World Health Organisation (2013), Global Health Observatory (GHO): www.who.int/gho/mortality_burden_disease/life_tables/situation_trends_text/en/.
14. Self-rated health status reflects people's overall perception of their health. Survey respondents are asked a question such as: "How is your health in general? Is it very good, good, fair, poor, very poor?"
15. See WHO (2004), Morality and Burden of Disease from Water and Sanitation, GHO: www.who.int/gho/phe/water_sanitation/burden/en/.

16. The environmental burden of disease quantifies the amount of disease caused by environmental risks. Disease burden can be expressed in deaths, incidence or in Disability-Adjusted Life Years (DALY). The latter measure combines the burden due to death and disability in a single index. Using such an index permits the comparison of a burden due to various environmental risk factors with other risk factors or diseases. WHO recent profiles of EBD for 192 countries refer to a core set of environmental risks that includes: i) water, sanitation and hygiene; ii) indoor air; and iii) outdoor air.
17. In countries with strong welfare systems a poverty trap can develop where it does not pay people to access such work and lose the benefits and cash transfers which have become necessary to meet high living costs. A number of cities, including Glasgow and Cape Town, have developed “living wage” campaigns, with the public sector taking a lead by offering living wages to all their staff despite the budget constraints associated with the global economic crisis.
18. Some 232 metro areas in 22 countries accounted for 56% of employment creation. Denmark, Greece, Japan and Portugal are excluded from this figure, as they experiences net job destruction over the period. Hungary and Slovenia are excluded for a very different reason: employment creation in the metropolitan areas exceeded that for the country (in other words, employment in non-metropolitan places fell) (OECD, 2013f).

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Chapter 3

Towards a multidimensional framework for inclusive growth

What is behind the increase in inequalities? How have rising inequalities affected growth in living standards? Building on the OECD's work on well-being, this chapter introduces an innovative analytical policy framework to examine the main drivers behind the rise of inequalities discussed in the preceding chapter. Proposing a novel measure of multidimensional living standards (comprising household disposable income, employment status, and longevity) the chapter identifies their growth for different segments of the population, and considers the impact of individual policies. The analysis shows that over the period immediately prior to the crisis, from 1995 to 2007, growth in multidimensional living standards across the OECD area was somewhat lower for the median household and the poor (those in the lowest decile) than for the "average" household.

Chapter 2 provided an array of evidence that income inequality has been rising for some time in many OECD countries, including in those where it was formerly relatively low, and that it remains high, and is even rising, in many developing countries and emerging market economies. In all countries, there are also major differences in non-material outcomes between different socio-economic groups. Everywhere, those at the upper end of the income distribution have a greater probability of obtaining a job, having a high level of education, being healthy and having a high life expectancy, and of living in an unpolluted environment, or, more generally, in a place where access to jobs and the benefits of society lead to a higher quality of life. In general, worse outcomes along the non-income spectrum are correlated with being in the lower levels of the income distribution.

This chapter discusses the main drivers of rising income inequalities in most OECD countries, as well as in several developing countries and emerging market economies, and proposes a multidimensional policy framework for Inclusive Growth building on the OECD's work on well-being, income inequality and pro-growth structural policies.

3.1. Why have inequalities risen?

Drivers of inequalities in OECD countries

In OECD countries, the single most important driver of rising income inequality has been greater dispersion in wages and salaries. Earnings account for about three quarters of household income among the working-age population (OECD, 2011a). In most cases, as discussed in Chapter 2, the earnings of the richest 10% of employees have increased more rapidly than those of the poorest 10%. There are a number of factors behind this trend:

- **Globalisation is often said to be the main culprit for rising wage inequality and unemployment, but data suggest that its effect has been limited, at least in the OECD area** (Box 3.1). Some feared that low-income workers were disproportionately affected by import competition, and that the offshoring of activities in the tradable goods and services sectors had decreased the demand for less-skilled labour. Increased imports from low-income countries tend to heighten wage dispersion, but only in countries with weaker employment protection legislation (OECD, 2011a). OECD analysis (OECD, 2013a, and OECD, 2011a) suggests that rising trade integration has had a limited impact on wage inequality and employment. The impact of globalisation on inequality has been minor compared with that of changes in technology (Jaumotte et al., 2008).
- **Technological progress has been more beneficial to higher-skilled workers, especially in OECD countries.** For decades, technological progress has raised productivity more quickly in manufacturing than elsewhere, reducing the demand for labour, especially low-skilled labour.¹ Combined with greater trade openness, this trend has also created large numbers of low-skilled manufacturing jobs in developing countries and emerging market economies. The more recent advent of ICT technologies has allowed people with the relevant ICT skills, or those specific to the financial sector, to enjoy significant income

Box 3.1. **Global Value Chains (GVCs): A new optic for studying trade and inequality?**

The consensus view in the inequality literature is that globalisation contributed to about 20% of rising wage inequality and that technological change has been more important than trade in causing changes in income distribution (WTO, 2008; and Newfarmer and Sztajerowska in OECD, 2012e). Yet the conclusion on the modest impact of trade is being increasingly questioned in the context of the rise of emerging economies and the growing international fragmentation of production (e.g. Krugman, 2007).

Differences in productivity and preferences drive international trade and result in efficiency gains and higher aggregate income, whereas trade distortions can be a source of both economic inefficiency and inequality. They lead to inequality within and across countries through the effects of tariffs, non-tariff barriers (NTBs) and trade-related regulations which are unevenly distributed across different economic sectors and activities; differences in market entry barriers and incentives to rent-seeking along different sectors and segments of Global Value Chains (GVCs); and policies that discriminate by geographical origins of trade, such as is the case with some regional trade agreements (RTAs). In all cases, the intention is to generate or preserve rents.

Kaplinsky (2001) argues that when segments or actors within a value chain are protected from competition they will enjoy higher rents and thus capture a higher share of value added. Additionally, value chains usually involve some degree of “governance” with certain key actors within the chain taking responsibility for the division of labour across different segments of the chain, and for its evolution. Thus, it is important how and on what terms a producer participates in the global economy (e.g. buyer-driven chains in textiles and clothing or producer-driven chains in motor vehicles manufacturing). Finally, the effectiveness of value chains arises from systemic efficiency; namely closer co-operation between links in the chain rather than improving the efficiency of individual links. These characteristics of GVCs affect the distribution of value added along the chain and thus the distribution of income across and within countries. According to Kaplinsky (*op. cit.*) barriers to entry and competition are key determinants of the distribution of rents, with those who command rents (e.g. associated with their brand name recognition or copyrights), or who have the ability to create new domains of rent, tending to gain, and those stuck in activities with low barriers to entry tending to lose out. The ability to identify rent-rich activities along the whole chain of value-added then provides the key to understanding the global appropriation of the returns to production. Along the same lines, Brewer (2011) stresses important links between the GVC and the analyses of global income inequalities. The traditional application of the GVC approach was to investigate the geographical dispersion, governance and institutional context of a given chain to illuminate the ways in which the most powerful actors and agencies organise the chain for their own benefit. More recently however, GVC analysis has focused on the concept of “upgrading” namely ways of improving the competitive position of particular value chain participants and capturing higher shares of value added, with an implicit assumption that such upgrading can aid national development. Such upgrading can involve moving into more technologically demanding manufacturing processes, but also the processing of agricultural and metal and mineral products with higher value-added.

While GVCs provide developing countries with the opportunity for economic and social upgrading, such outcomes are not a given. Evidence from Africa suggests that while poorer countries benefit most of the time from increasing GVC integration in the form of more and better employment, such upgrading has been less evident for example in South Africa’s textile industry (OECD, 2014a). Moreover, GVCs are not gender neutral and reflect broader gender inequality and discriminatory social norms within households, communities and economies. While women are important participants in the GVCs, their opportunities for economic empowerment are limited due to gendered division of labour and low economic value attributed to their contributions (Barrientos, 2013). The bargaining position and support provided to weaker value chain participants, such as small producers, unskilled workers and women, are essential to helping them upgrade. Policies need to be tailored to specific upgrading strategies and institutional contexts, which vary by sectors and countries. However, private governance and public policies may strongly affect the inclusiveness of GVC participation and upgrading (A. Goger et al., 2014).

gains, while workers with low skills have been left behind. As a result, the earnings gap between high and low-skilled workers has grown. In some countries like the United States, skill-based technical change induced a shift in labour demand towards higher skills. Yet, the supply of such individuals has not kept pace with rising demand, as indicated by the slowing growth of tertiary educational attainment (O. Denk et al., 2013).

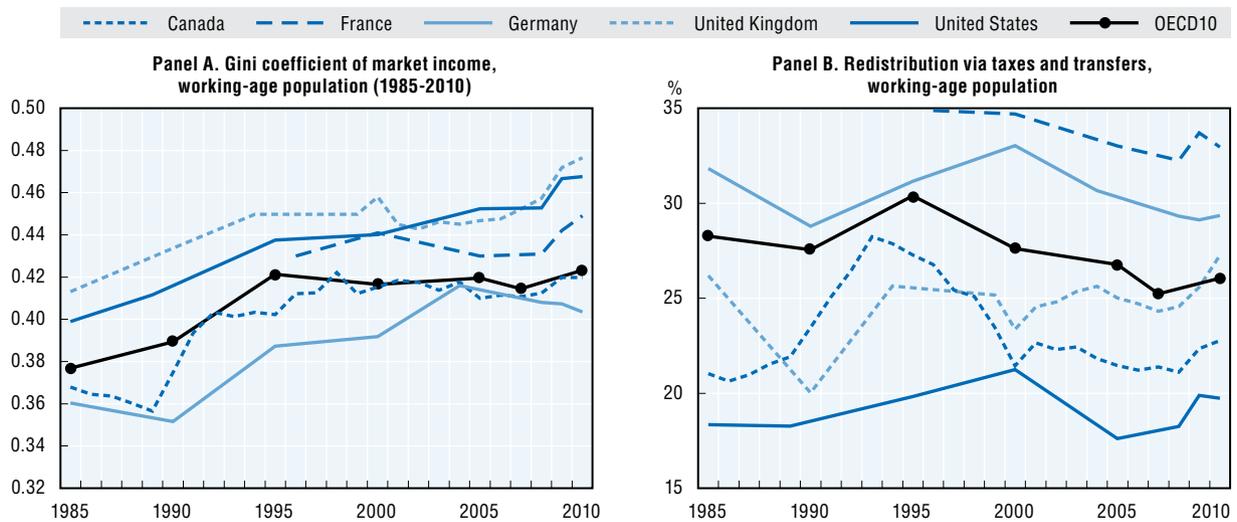
- **Regulatory reforms and institutional changes leading to increased competition and greater flexibility in product and labour markets have increased employment opportunities, but also contributed to greater wage inequality.** Since the 1980s, OECD countries have carried out significant regulatory reforms to strengthen competition in the markets for goods and services and to make labour markets more adaptable. Reforms include the removal of barriers to competition in product market regulations, more flexible employment protection legislation (EPL) for workers with temporary contracts, and in some cases reductions in the minimum wage. Unionisation rates also fell in most OECD countries. These reforms had positive impacts by promoting job creation in the short run, but the fact that permanent workers continued to enjoy stricter EPL relative to their peers on temporary contracts in most countries contributed to rising labour market segmentation and deteriorating job quality (OECD, 2013a).
- **Changes in working conditions have contributed to rising earnings inequality.** In many countries, there has been an increase in the prevalence of part-time and atypical labour contracts, as well as a reduction in the coverage of collective-bargaining arrangements. As mentioned in Chapter 2, some population groups, including women and youth, often only work part-time and tend to suffer from a wage gap with other groups.
- **Changing family structures are making household incomes more diverse, while reducing economies of scale and making for increased earnings inequalities.** Household structures have changed profoundly over recent decades. There are more single-headed households today than ever before; in the mid-2000s, they accounted for 20% of all working-age households, on average, in OECD countries. Smaller households are less able to benefit from the savings associated with pooling resources and sharing expenditures. Therefore, a trend toward smaller households is likely to increase earnings and income inequality. Marriage behaviour has also changed. People are now much more likely to choose partners in the same earnings bracket, which tends to reinforce income inequality (Chen et al., 2014; Greenwood et al., 2014). However, the combined effects of demographic and societal changes have accounted only for a minor share of increased household earnings inequality, much less than labour market related factors (OECD, 2011a).

Rising shares of non-wage income from capital have also increased household income inequality. Capital income inequality has increased more than earnings inequality in most OECD countries (OECD, 2001a). But, at around 7%, the share of capital income in total household income still remains modest on average, although richer individuals tend to receive a larger share of their income from capital. Wealth-to-income ratios have risen sharply in OECD countries since the mid-20th century. The challenge this trend poses for policy making is that wealth is transmitted across generations, perpetuating inequalities in both wealth and the incomes derived from it. An Inclusive Growth policy response could be progressive taxation of wealth and more progressive inheritance taxes. Both would be difficult to implement in an environment of increased cross-border capital mobility.

The global crisis and its financial roots have revived a debate on the impact of financial deepening on inequalities.² By bringing together savers and borrowers, with their very different attitudes and needs regarding liquidity and risk, financial markets aid growth. Lack of access by households and would-be entrepreneurs to credit is often cited as a barrier to development in poorer countries. In rich countries with highly developed financial markets, their impact on long-term growth is less clear-cut: “Finance is a powerful tool for economic development but with important non-linear effects” (Beck, 2013). The recent global financial crisis underlines the importance of regulatory frameworks that discourage financial market operators from risky activities, often divorced from the core business of financing real investment, that bring them exceptionally high rewards in good times, but greatly harm the real economy when risks materialise. The exceptionally high rewards themselves exacerbate inequality of earnings and also attract a high share of the highly-skilled, so that productivity suffers in other sectors that depend on skilled human capital (Kneer, 2013).

Finally, tax and benefit systems have become less redistributive in many countries since the mid-1990s. Until the mid-1990s, tax-benefit systems in many OECD countries offset more than half of the rise in market-income inequality. However, while market income inequality flattened after the mid-1990s, inequality of household disposable income continued to rise as the stabilising effect of taxes and benefits declined. The main reasons for the decline in redistributive capacity are found on the benefit side: reduction in benefit generosity, a tightening of eligibility rules to limit expenditures for social protection, and the failure of transfers to the lowest income groups to keep pace with earnings growth (OECD, 2011a). Currently, cash transfers and income taxes reduce income inequality by one quarter among the working-age population (Figure 3.1).

Figure 3.1. Although less redistributive than in the past, cash and transfer benefit systems still mitigate inequality among the working age population



Note: Redistribution is measured as the difference between «initial» inequality (Gini of market income) and «final» inequality (Gini of disposable income), as a percentage of initial inequality.

1985 refers to 1984 for the United States. OECD average: un-weighted and based on 10 countries for which data are available at all points (Canada, Denmark, Germany, Israel, Italy, Netherlands, New Zealand, Sweden, United Kingdom and United States).

Source: OECD Income Distribution Database (2013), www.oecd.org/social/income-distribution-database.htm.

Drivers of inequalities in emerging market economies and developing countries

There are additional driving forces of income inequality in emerging market economies and developing countries. The key culprits are a combination of marked spatial divides, widespread informality in the labour market and among SMEs, and disparities in access to education and skills (OECD, 2011a). In particular:

- **Widespread informality is a major cause of inequality.** In spite of rapid economic growth in most developing countries, more than 50% of all jobs in the non-agricultural sector worldwide are informal (OECD, 2009). Informal workers generally have low-paid, low-productivity jobs and often do not have access to formal social safety nets. They also work in small, unregistered businesses with limited opportunity for expansion, perpetuating a vicious circle of exclusion, low productivity and inequality. In Latin America, some countries, like Brazil, have seen a significant decrease in informal employment since the mid-1990s, but in others, like China, India, Indonesia, and South Africa, informality has actually increased. In most Sub-Saharan African countries, informal sector employment, in particular self-employment, remains the dominant form of work (OECD, 2012a).
- **Spatial disparities in economic outcomes can stem from power imbalances between advantaged and lagging regions,** coupled with institutional weaknesses and ethnic disadvantages. The specific forces behind observed patterns of spatial inequality vary among countries. They might be linked to disparities in access to basic services between rural and urban populations (e.g. China) or imbalances between different regions (India). They may also be linked to historically disadvantaged ethnic and social groups that are concentrated in particular regions (e.g. South Africa, Viet Nam). As mentioned in Chapter 2, emerging market economies like China and India and, to a lesser extent, South Africa, have experienced increases in income inequality within urban and rural areas alike since the early 1990s, with increases particularly in urban regions. Other countries, like Viet Nam, have seen a trend of increasing inequality in rural areas, even if inequality also worsened in urban areas during the crisis (OECD, 2014b).
- **Another important factor driving income inequality is access to quality education and skills.** Across the developing world, enrolment in primary and secondary education varies markedly between population groups. Household income has an important effect on the educational attainment of children, and spatial and gender disparities persist, with rural populations generally less educated than urban populations, and girls of primary-school age being more likely than boys to be out of school in several African and Southern Asian countries (OECD, 2012b). Over the past two decades, however, important progress has been made in both primary school attendance, and youth and adult literacy. Primary school enrolment rates in developing countries grew from 83% in 2000 to 90% in 2011, and global adult literacy rates grew from 76 to 84% over the same period.³ In Latin America, 51% of the young population between 20 and 24 years of age completed secondary education in 2006, compared to only 27% in 1990. The increase in enrolment was a key factor in the reduction in income inequality in the region (OECD, 2012d).

In emerging market economies, the benefit and tax systems have a smaller role in easing market-driven disparities in earnings than they do in most OECD countries. The coverage and generosity of social protection systems is generally lower in emerging market economies than in most OECD countries. Public social expenditure is highest in Brazil and Russia, where it represents about three-quarters of the OECD average of about 20%

of GDP, whereas in China and India public social expenditure is three to four times lower than the OECD average (OECD, 2011a). In low and middle income countries, public social expenditures are much lower than the OECD average (OECD, 2014b and OECD, 2014b).⁴ More importantly, the tax system in emerging market economies delivers only modest redistribution, reflecting greater reliance on indirect, rather than direct taxes.

Social protection is underdeveloped in many developing countries. More than 80% of the global population lack basic protection in the event of unemployment, sickness, disability, widowhood, old age or other adverse shocks to income (ILO, 2008). In many less-developed nations, social security mainly benefits civil servants and state employees. Informal workers are excluded from the social security system, and fiscal spaces do not allow sufficient domestic resources to be mobilised to fund broad social protection programmes.

3.2. Growing unequal amid rising prosperity: Why care about it?

In those countries where inequalities have been widening, it is worrying that the “rising tides” continue to raise the biggest boats the fastest. Some level of inequality is to be expected in all economies. The arguments about the impact of the level of inequality on economic growth go both ways (Box 3.2). In OECD countries, the period of fast GDP growth from the 1950s to the oil shocks of the 1970s was accompanied by generally falling levels of income inequality (Sawyer, 1976). Since then, per capita GDP growth has been on a falling trend, but income inequalities have risen again in many OECD countries, especially at the high ends of the income distribution. In many fast-growing emerging economies, income inequalities are higher than in OECD countries, and they continue to rise. The reasons for these developments are now well understood, but they were not predicted before they became noticeable. Although attitudes towards incomes inequalities differ across societies, very few would argue that persistently rising inequality is an inevitable, healthy and welcome accompaniment to economic growth, and even the current levels of inequality in countries at very different stages of development have become a matter of political concern.

There are many reasons to care about rising income inequality. Income inequality reduces social mobility, making it more difficult for innately talented people from low-income backgrounds to rise above their origins while enabling the descendants of the rich to enjoy high living standards with little effort. Intergenerational earnings mobility is high in the Nordic countries, where income is more evenly distributed, and low in countries with higher inequality, such as Italy, the United Kingdom and the United States (OECD, 2008). Inequality within countries also raises political challenges by breeding social resentment and generating political instability by fuelling populist, protectionist and anti-globalisation sentiment. People will no longer support open trade and free markets if they feel that they are losing out while a small group is prospering. In some parts of the world, such as in Northern and Southern Africa, the effect of persistently high unemployment combined with severe levels of inequality has already resulted in social instability.

Inequalities of income and opportunity undermine the economy’s performance, even if the relationship is not straightforward. The literature shows that income distribution is linked to macroeconomic performance through complex, multidimensional transmission channels. Economic performance might be stimulated or inhibited depending on

Box 3.2. The Inequality-Growth nexus

More than 3 out of 4 OECD countries, including traditionally more equal countries registered widening inequality this century when growth was rapid; if anything this trend has accelerated in the aftermath of the crisis, as employment growth remains sluggish and fiscal consolidation takes hold. This disturbing development raises the question of whether greater inequality increases growth? Or, on the contrary, does it hold growth back?

There are a number of ways in which wider inequality might affect growth. It might **reduce growth** if:

- a) Greater inequality becomes unacceptable to voters, so they insist on higher taxation, regulation, or even confiscation of property, all of which may reduce the incentives to invest.
- b) In extreme cases, inequality may lead to social unrest, and economic chaos.
- c) Poor people cannot borrow money. If this is the case, then they may not be able to afford worthwhile investments, even if the rate of return is high. They may choose to leave full-time education if they cannot afford to pay fees, even though the rate of return (to both the individual and society) is very high.
- d) People no longer trust business, and pro-business policies.

On the other hand, greater inequality might **increase growth** if:

- e) High inequality encourages people to invest to take advantage of high rates of return. For example, if highly educated people are much more productive, then high differences in rates of return may encourage more people to seek education.
- f) Similarly, if the rewards are high, people might work harder and be prepared to take more risks in order to get higher incomes.

Many empirical attempts to explain the links between inequality and growth have been inconclusive. Up to now, evidence has strongly supported hypothesis b), particularly in low income countries and largely rejected hypothesis a); and has been inconclusive on the other hypotheses. However, this lack of evidence often reflects methodological and data problems, and it is possible to be more assertive about the types of inequality which should concern policy makers. In the real world, inequality often arises from circumstantial factors (socio-economic or family background, race), or individual actions and effort. The former set of causes is bad for growth, not just equality, regardless of whether the latter may be more complex to analyse. Tackling racism, sexism, and promoting equality of opportunity are good for growth and good for equality.

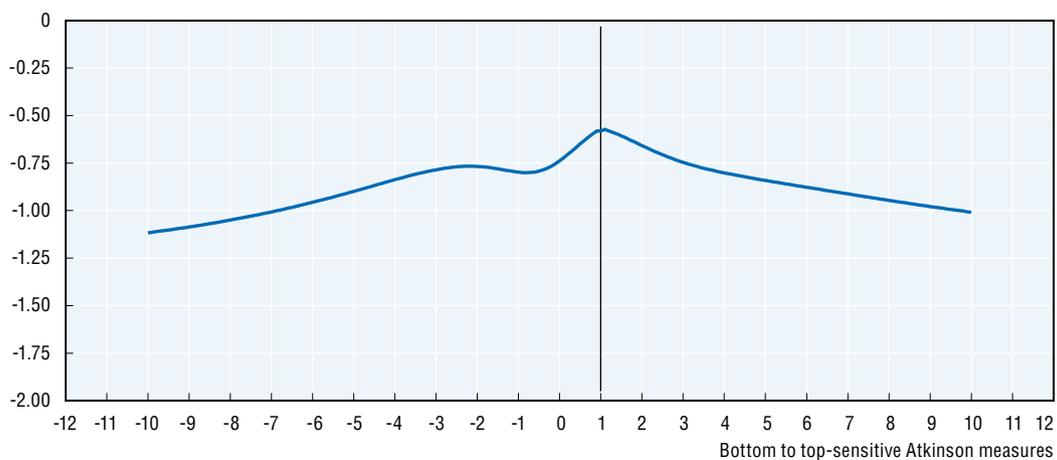
Furthermore, the reality of income inequalities is more complex than the simple Gini coefficient measure. For example, evidence suggests that rising inequality in the bottom half of the distribution reduces investment in education and is bad for growth, whereas rising inequality in the top half of the distribution encourages entrepreneurship and effort and is good for growth. At the same time, if inequality is restricted to the top 1% of the distribution, there may not be much room for “trickle down” effects of growth. In some OECD countries, more than 40% of long-term income growth has been captured by the top 1%.

Hence the message to policy makers is: understand the causes of changes in inequality. Sometimes increasing inequality will be a prerequisite for higher growth returns. Often, however, tackling inequality will be an important driver for improving growth.

the prevailing overall level of inequality as well as how inequality is shaped: positive mechanisms running from inequality to GDP growth can be linked to inequality at the top end of the distribution while negative effects can be traced to bottom-end inequality e.g. poverty (Barro, 2000). As a result the shape of the income distribution also matters, and inequality at different segments of the income distribution can affect GDP differently. These theoretical findings (see for example Aghion and Bolton, 1997 and Galor and Moav, 2004) are supported by empirical analysis by the OECD (Figure 3.2). Overall, the impact is invariably negative and statistically significant: a 1% increase in inequality lowers GDP by 0.6% to 1.1% depending on the strength of the aversion. However, the symmetry of the curve implies that inequalities at the top and the bottom of the income distribution have almost the same effect on GDP.

Figure 3.2. **Income inequality affects GDP across the distribution**

GDP elasticities to inequality for different segments of the distribution



Note: Elasticity estimated from the joint estimation of GDP and household incomes equations.

Source: Causa, O. et al. (2014b), "Economic Growth from the Household Perspective: GDP and Income Distribution Developments Across OECD Countries", *OECD Economics Department Working Papers*, No. 1111, OECD Publishing, Paris, <http://dx.doi.org/10.1787/5jz5m89dh0nt-en>.

3.3. Defining Inclusive Growth

A diversity of approaches

There are different approaches to Inclusive Growth, which at their root share a call for growth that combines increased prosperity with greater equity. In some cases, emphasis is placed on productive employment, so that economic growth can generate the jobs needed to absorb growing populations, meets the demands of the private sector for skills and competencies, and ensure that workers reap the benefits of rising productivity. Other approaches emphasise pro-poor growth, aiming to deliver higher income gains for low-income groups than for the rest of the population, and in doing so help to reduce inequalities in living standards. There are still other approaches that focus on the economic and non-economic opportunities generated by growth and on sharing the benefits of growth in terms of quality of jobs, the health and education status of the population and/or the skills of the labour force.

Despite the absence of a unifying concept, governments are increasingly putting Inclusive Growth at the core of their policy strategies. This is the case with India's 12th Five Year Plan and the European Union's Europe 2020 Strategy, where Inclusive Growth

is presented as an emerging model for growth. Although no explicit mention is made of Inclusive Growth, the New Zealand Treasury has also endorsed a vision of living standards that emphasise both economic growth and distributional considerations. Scholars and international organisations are also working on the definition and measurement of Inclusive Growth (Box 3.3).

Box 3.3. The definition of Inclusive Growth in the work of other International Organisations

The **World Bank** refers to Inclusive Growth to denote both the pace and pattern of economic growth, which are interlinked and assessed together. In the World Bank approach, a rapid pace of economic growth is necessary for reducing absolute poverty. But, for this growth to be sustainable in the long run, it should be broad-based across sectors, and inclusive of most of a country's working-age population. This definition implies a direct link between the macro and micro determinants of growth. In this perspective, Inclusive Growth focuses on productive employment, rather than on employment per se, or income redistribution. Employment growth generates new jobs and income, while productivity growth has the potential to lift the wages of workers and the returns of the self-employed. The World Bank's approach adopts a long-term perspective and is concerned with sustained growth, where inclusiveness refers to equality of opportunity in terms of access to markets, resources and unbiased regulatory environment for businesses and individuals.

The **Asian Development Bank (ADB)** framed its corporate strategy (Strategy 2020) aiming to promote inclusive economic growth as one of its main objectives. In this framework, Inclusive Growth is a concept that goes beyond broad-based growth. It is a type of "growth that not only creates new economic opportunities, but also one that ensures equal access to the opportunities created for all segments of society, particularly for the poor" (Ali and Hwa Son, 2007). An income growth episode is considered "inclusive" when it:

- allows participation of (and contribution by) all members of society, with particular emphasis on the ability of the poor and disadvantaged to participate in growth (the "non-discriminatory" aspect of growth). This implies a focus on the "process" of growth; and
- is associated with declining inequality in those non-income dimensions of well-being that are particularly important for promoting economic opportunities, including education, health, nutrition and social integration (the "disadvantage-reducing" aspect of Inclusive Growth). This implies a focus on the "outcomes" of growth.

The **UNDP** recently changed the name of its International Poverty Centre in Brasilia to International Policy Centre on Inclusive Growth (IPC-IG), whose work is based on the premise that more equal societies perform better in development. In the UNDP perspective, Inclusive Growth is seen as both an outcome and a process. On the one hand, it ensures that everyone can participate in the growth process, both in terms of decision-making as well as in terms of participating in growth itself. On the other hand, Inclusive Growth is one whose benefits are shared equitably. Inclusive growth thus implies participation and benefit-sharing.

The **Europe 2020 Strategy** has the notion of Inclusive Growth at its core. In this Strategy, Inclusive Growth is understood as "empowering people through high levels of employment, investing in skills, fighting poverty and modernising labour markets, training and social protection systems so as to help people anticipate and manage change, and build a cohesive society. It is also essential that the benefits of economic growth spread to all parts of the Union, including its outermost regions, thus strengthening territorial cohesion. It is about ensuring access and opportunities for all throughout the lifecycle".

The OECD approach to Inclusive Growth

A multidimensional policy framework for Inclusive Growth can be built on the OECD's work on well-being, income distribution and the effects of structural reforms on economic performance. At the heart of this approach is a definition of Inclusive Growth as "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.” In particular, a three-pronged approach can be based on:

- **Multidimensionality.** There is widespread recognition that gross domestic product (GDP) captures only part of economic welfare and excludes other dimensions which also matter for well-being, such as jobs, skills and education, health status, environment, and civic participation and social connections. Multidimensionality draws on the OECD work on well-being (Box 3.4), which emphasises a set of key outcomes that are essential for the development of people’s capabilities and well-being and that allow them to participate in both the economy and society.

Box 3.4. OECD work on well-being

For more than ten years, the OECD has been looking beyond the functioning of the economic system to consider the diverse experiences and living conditions of people and households. Measuring the well-being of people and the progress of societies is the main goal of the OECD Better Life Initiative (www.oecd.org/betterlifeinitiative). The Initiative, that was launched in May 2011 on the occasion of the OECD’s 50th Anniversary, focuses on developing statistics that can capture aspects of life that matter to people and that, taken together, help to shape the quality of their lives. The OECD conceptual framework for measuring well-being focuses on people, outcomes (average and their distribution) and includes both objective and subjective aspects of well-being. It distinguishes between current and future well-being. Current well-being is measured in terms of outcomes and their distribution across the population achieved in the two broad domains: material living conditions (i.e. income and wealth; jobs and earnings; housing conditions) and quality of life (i.e. health status; work-life balance; education and skills; social connections; civic engagement and governance; environmental quality; personal security; and subjective well-being). To assess the sustainability of well-being over time, the OECD focuses on four different types of resources (or “capitals”) that can be measured today, and that matter for the well-being of future generations: economic, natural, human and social capital. Two important elements of the *Better Life initiative* are the *How’s Life?* report and the *Better Life Index*. *How’s Life?*, published every two years, provides a comprehensive picture of well-being in OECD countries and other major economies, by looking at people’s material conditions and quality of life across the population. The *Better Life Index* is an interactive web-based tool that allows citizens to compare well-being across OECD countries and beyond.

Source: OECD (2013b), *How’s Life? 2013: Measuring Well-being*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264201392-en>; OECD (2011b), *How’s Life?: Measuring Well-being*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264121164-en>.

- **Emphasis on distribution.** Inclusive Growth means that people, independently of their socio-economic background, gender, place of residence or ethnic origin, should have fair opportunities to contribute to growth (i.e. they are part of the growth process), and that their contribution should yield equitable benefits (i.e. they benefit from the outcomes of the process). The OECD work on trends and policy drivers of income distribution, including in *Divided We Stand, Going for Growth, Perspectives on Global Development*, among other studies, provides an important pillar for the work on Inclusive Growth. In addition, the OECD’s Inclusive Growth approach aims at capturing how particular parts of the

population fare not only with respect to income but also with respect to other dimensions of well-being, such as health.

- **Policy relevance:** Inclusive Growth should be policy-actionable and must make a link between policy instruments and the relevant monetary and non-monetary dimensions, taking into account distributional impact. This requires in particular assessing the impact of policies and institutions on the different dimensions, as well as the trade-offs and complementarities that are expected to exist between pro-growth and pro-inclusiveness policies among the relevant dimensions. A policy-relevant and operational approach to Inclusive Growth calls for a policy toolkit that allows policy makers to exploit synergies among mutually-reinforcing policy levers and to take compensatory action when trade-offs are identified. The OECD has done considerable empirical work to “map”, or establish causal linkages, between policies and outcomes which provides a rich body of evidence that informs the work on Inclusive Growth.

Which dimensions matter for Inclusive Growth?

The first key pillar of the OECD approach – multidimensionality – draws insights from the Well-Being Framework. In *How's Life?* (OECD, 2011b and OECD, 2013a), a set of eleven monetary and non-monetary dimensions are identified as essential for people's well-being. These include areas such as income and wealth, jobs, skills and education, health, social connections, environmental quality and security. While all dimensions are clearly relevant for well-being, the focus that Inclusive Growth takes is somewhat more specific. This arises in particular from the need to quantify and assess policy links. For the purpose at hand, it was thus necessary to select a sub-set of the well-being dimensions. Three criteria were considered for this selection: an actionable link to policy, measurability in OECD countries and beyond and relative importance as determinants of people's subjective well-being. This led to the selection of household income, health status and jobs as the three most salient dimensions for the OECD's Policy Framework for Inclusive Growth. This will not preclude the examination of additional dimensions in the future, such as education and the environmental quality of life, as these also rank highly as determinants of people's well-being.

The relevant dimensions of Inclusive Growth may vary across countries depending on their level of development, social preferences, specific conditions and circumstances. In particular, other dimensions may be relevant for developing countries, such as social connections, civic engagement and the quality of institutions, including: personal and professional networks, citizens' influence on collective decisions, and trust in public institutions. Economic growth may affect social connections by shaping people's opportunities to meet and socialise in workplaces (e.g. through hours worked, atypical workers, etc.) but also in the broader community, (e.g. through migration, longer commuting times). Weak economic growth can bring a decline in trust in public institutions. Another dimension to consider is *personal security*, including safety in conflict and post-conflict situations, violence against women and children, and the problems associated with criminality, which impact on economic growth and human development. *Infrastructure and housing*, including access to decent homes, sanitation, safe water, transport and other basic infrastructure could also be relevant to emerging economies and developing countries. This is also the case for *social protection*, including the availability of and access to services, such as social security, assistance programmes, and unemployment insurance, which tend to be more developed in more advanced societies. Moreover, *food security*, including livelihoods

threatened by climate change and efforts to deal with biodiversity, is a particular challenge for a large number of developing countries, where agriculture remains the single most important sector. People may lack access to sufficient, safe and nutritious food to meet their basic needs and ensure that they lead to a healthy and productive life.

How can distributional aspects of Inclusive Growth be measured?

The second key pillar of Inclusive Growth – emphasis on distribution – requires an innovative method for comparing multidimensional well-being outcomes across the population. This is a complex undertaking, but can be approached by identifying a “representative household” and aggregate monetary and non-monetary outcomes in a single, multidimensional, measure of “overall living standards” that can be used to assess policy alternatives (Boarini et al., 2014). In particular:

- **The “representative household”.** In conventional analysis of the effects of structural policies on economic growth, emphasis is placed on an “average” individual or household, and outcomes are described as the mean values of conventional indicators. This is the case of empirical evidence of how specific policies, for example, in the area of innovation, education, environmental regulation, affect per capita (mean) income, which has been the approach taken in *Going for Growth*. However, as shown in Chapter 2, well-being outcomes are very unequally distributed, which calls for gauging the effects of policies not only on the mean, but also at other points of the distribution. One such point is the median, representing the value that cuts the distribution into two equal parts. Thus, the income of a median household or person is much more representative for the income of the population at large or of the “middle class” than a simple average. OECD work is increasingly shedding light on the policy impacts on different segments of the distribution. In many developing and emerging countries, it may also be important to focus on additional segments of the distribution of income, such as on those individuals with income at the poverty line.
- **The notion of “overall living standards”.** In a multidimensional concept of Inclusive Growth, different dimensions must be measurable in a comparable way. One way of doing this is to use the principle of equivalent income, which is defined as the hypothetical income that would make an individual indifferent between their current situation and a benchmark situation (typically, the best possible outcome in non-income dimensions). The contribution – positive or negative – of the non-income components to multidimensional living standards is measured by the monetary value that households are willing to pay to enjoy, or get rid of, those components. The empirical computation of equivalent income is complex, and important challenges need to be addressed, but conventional techniques can be used, as in the illustration below.

The emphasis placed by Inclusive Growth on different points of the distribution of outcomes makes it flexible for policy analysis. For example, Inclusive Growth could be used to assess the effects of pro-growth policies on different income groups. In contrast to conventional pro-poor growth studies (e.g. OECD, 2006), where the analysis focuses on the incomes of a particular low-income group, the approach detailed below identifies if growth has been especially favourable to particular income groups, and it can be extended to cover non-income dimensions. This approach relies on the use of the Generalised Mean Framework (Boarini et al., 2014) (Box 3.5).

Box 3.5. Using Atkinson's generalised means to aggregate welfare across individuals

General means are grounded in Atkinson's (1970) framework for inequality and welfare analysis and belong to the family of "equally distributed welfare" functions. Formally, general means are defined as follows:

$$w_{1-\tau} = \left(\frac{1}{n} \sum_i w_i^{1-\tau} \right)^{\frac{1}{1-\tau}} \text{ for all } \tau \neq 1 \text{ and } w_{1-\tau} = \left(\prod_i w_i \right)^{1/n} \text{ for } \tau = 1.$$

where the vector $w = (w_1, \dots, w_n)$ measures the welfare distribution, $w_i > 0$ is the welfare of the i -th person, and n is the population size.

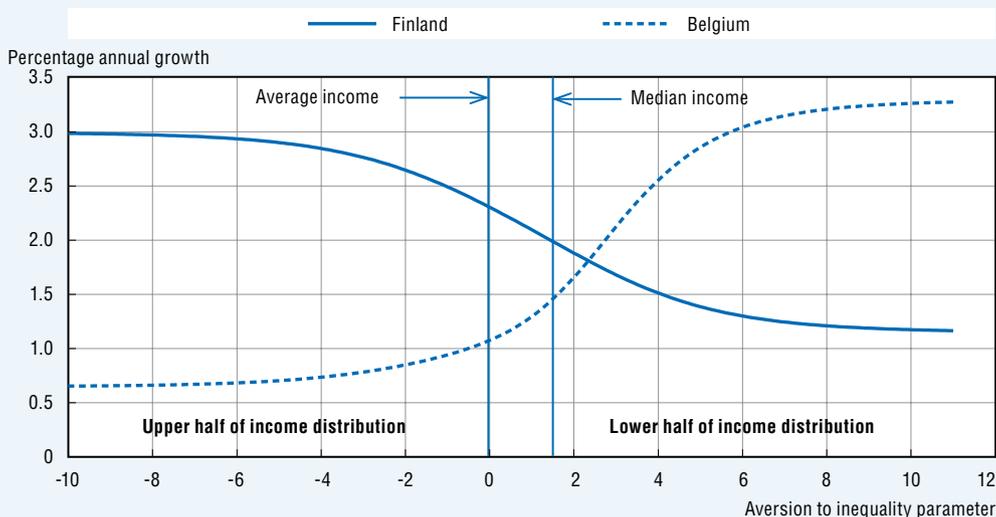
The general mean reduces to the standard mean when $\tau = 0$ and to the geometric mean when $\tau = 1$. The general mean of individual welfare places greater weight on higher welfare individuals and less weight on lower welfare individuals as the parameter rises. Hence τ is sometimes interpreted as a measure of the level of inequality aversion.

In the simple case where individual welfare is defined in income alone, the general mean is called "income standards" (Foster and Szekely, 2008). An ongoing OECD project uses income standards to look at the evolution of income growth across the whole distribution (Causa et al., 2014). This approach, which builds on Foster et al. (2013) and is also used by the World Bank for tracking income inclusiveness has been applied to all OECD countries from mid-1990s to the end of 2000s.

Figure 3.3 for Belgium and Finland, two countries that experience opposite trends in growth of income standards. In Belgium, between 1995 and 2009, incomes grew faster among households in the lower half of the distribution and particularly so among the poorest. By contrast, Finland recorded a marked increase in income growth among households in the upper half of the income distribution.

Figure 3.3. **Income growth has benefitted different social groups:
The cases of Belgium and Finland**

Annual growth of households income at various points of the distribution, 1995-2009



Source: OECD calculations based on Causa, O. et al., 2014.

How can a multidimensional approach to Inclusive Growth become policy-actionable?

The third key pillar of Inclusive Growth – policy relevance – calls for careful “mapping” of policies to multidimensional outcomes. As noted above, conventional economic growth theory focuses essentially on *average* material living standards, whereas Inclusive Growth looks at the distributional effects of policies along the entire distribution of outcomes. The

task ahead is therefore more complex and requires a better understanding of the causal links between policies and outcomes in various areas. For instance, extensive work has been undertaken to explain the policy determinants of growth of GDP per capita and of labour market participation. However, much less is known about policy levers of *household income* specifically or of *health status*. Indeed, conventional analysis looks at the effects of policies on selected outcomes separately, whereas what is proposed here is a joint assessment of the impact of policies on a set of income and non-income outcomes that matter for well-being. For instance, tax and benefits policy has a direct influence on household disposable income but has also a complex impact on unemployment and an indirect influence on health status (if for instance taxation finances health expenditure). These aspects are further discussed at the end of this chapter.

3.4. An illustration of the Inclusive Growth Framework in practice

A three-dimensional measure of Inclusive Growth

A simple exercise can be used to illustrate the concept of Inclusive Growth. This illustration uses three dimensions: *unemployment* and *health status* as the non-income dimensions to be considered, along with household income (Box 3.6).⁵ In essence, inclusiveness is captured by relating to three dimensions of well-being (income, jobs, health) and by taking into account distributions of outcomes along these dimensions and across different population groups. Attention is placed on OECD countries and over the period 1995-2011, distinguishing before (1995-2007) and after the crisis (2007-11 or last year available).

Box 3.6. Measuring multidimensional living standards in practice

There are three steps to take when measuring multidimensional living standards at an aggregate level:

- measuring *income-related* living standards (captured for instance by consumption or real income) at the individual level. The approach here uses household real disposable income as the relevant measure, although from a conceptual viewpoint, a measure of household real net *adjusted* disposable income would be preferable (see Stiglitz et al., 2009); it is then necessary to bring the chosen non-material dimensions, i.e. unemployment and health, into the picture and to measure these dimensions at the individual level in order to combine them with measured material dimensions;
- expressing the non-income dimensions in a monetary metrics, using estimated shadow prices of non-income dimensions; and
- computing the broader living standard measure for the “representative” household.

There are specific reasons for choosing unemployment and health status in this illustration. The unemployment rate is a strong determinant of subjective well-being. Unemployment is also the variable that has repeatedly been used in the literature on the measurement of multidimensional living standards and well-being (Fleurbaey and Gaulier, 2009). At the same time, not all types of unemployment are equally relevant from the perspective of well-being. For instance, long-term unemployment and weak prospects of returning to work following a lay-off seem to be more detrimental than short spells of unemployment between jobs. The average rate of unemployment, which is used in this analysis, cannot distinguish between these features of the labour market. However,

analysis that has been carried out to consider alternative formulations (e.g. long term versus short term unemployment; unemployment turnover; employment) and their impact on the measure of Inclusive Growth shows that, overall, results are robust for these various alternative formulations.

Life expectancy, the measurement variable for health, is a standard gauge of longevity and is one of the best available measures of health status. Life expectancy, however, does not measure healthiness or quality of life (OECD, 2011b). In many studies the proxy used for healthiness is often a “self-reported health” variable, although this variable is subject to some measurement errors and is available for most countries only since the mid-2000s. Despite weak variability among countries, the number of years necessary to gain one extra year of life expectancy has varied significantly among OECD countries during 1995-2009, including among high-income OECD countries.⁶ OECD work has already documented links between life expectancy and environmental and life-style variables, as discussed below (Joumard et al., 2010).

Mortality measures have the twin advantage of being widely available for large sets of countries and of having long time series. They are very well documented and available by age, gender and, in some countries, by educational attainment (Sen, 1998; Mackenbach et al., 2008). Also, there are large and persistent inequalities in longevity within countries that tend to be correlated with the socio-economic background of individuals. Furthermore, the socio-economic determinants of inequality in longevity, such as the education gradient of mortality, are very different across OECD countries. The implication is that life expectancy is expected to play a significant role as determinant of multidimensional inequality and as a driver of cross-country differences in the level and evolution of multidimensional living standards. That said, it will be of interest to examine how simple measures of mortality compare with measures of morbidity or quality-adjusted measures of mortality once such data become available for a larger number of countries and time periods.

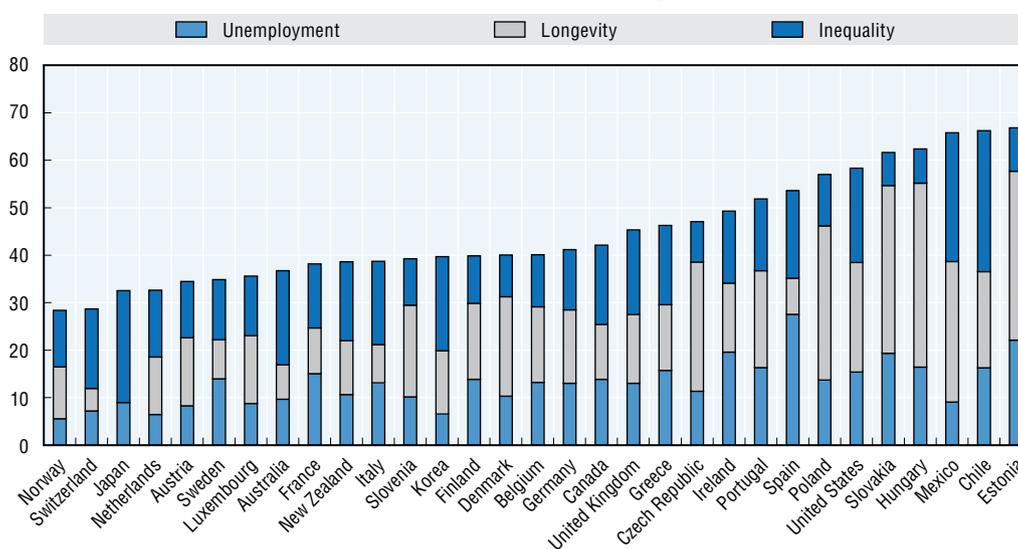
Two main findings: An illustration of multidimensional living standards

Multidimensional living standards can be compared across countries as a function of household disposable income. The representative household is the median household, and equivalent income for health reflects the monetised value of differences in outcomes relative to the sample’s reference country with highest life expectancy: Japan. For the jobs dimension, absence of unemployment has been taken as the reference value. Equivalent income then presents the loss in multidimensional living standards that a representative household in a particular country suffers by experiencing unemployment, an unequal distribution of household income, and shorter longevity than the reference country. On average, the total welfare loss associated with the three components represents as much as 45% of disposable income, with almost equal contributions of income inequality, health and unemployment (Figure 3.4).⁷ If the representative household is set not as the median household but as a household whose income corresponds to the bottom quartile of the income distribution, the estimated welfare loss would amount to as much as 63% of disposable income (with the loss due to income inequality amounting to 33% of disposable income).

Growth in multidimensional living standards and in GDP per capita may differ considerably, highlighting the relevance of multidimensionality for policy analysis on Inclusive Growth. Focussing on a set of 18 OECD countries between 1995 and 2007, and

taking median equivalent income as the reference for the analysis, we observe that all measures of multidimensional living standards show improvements over the period of analysis and would thus point to persistent Inclusive Growth based on our definition. This has to be put in perspective, however. The growth rate of multidimensional living standards for the median household is almost certainly biased upward, because our current measure of inequality only reflects inequality of disposable income, not inequality of equivalent income. Unemployment and life expectancy are distributed unequally across individuals (see for instance OECD, 2011b) and enhance the (mostly negative) effects of increasing inequality. This would in turn reduce the measured change in multidimensional living standards for the median household. Developing the data needed to capture inequality in jobs and health for all countries is therefore important in future work.

Figure 3.4. **Inequalities can impact living standards**
Contribution of losses as a share of household disposable income (2009)



Note: Aversion to income inequality is chosen so that living standards reflect the median household income.

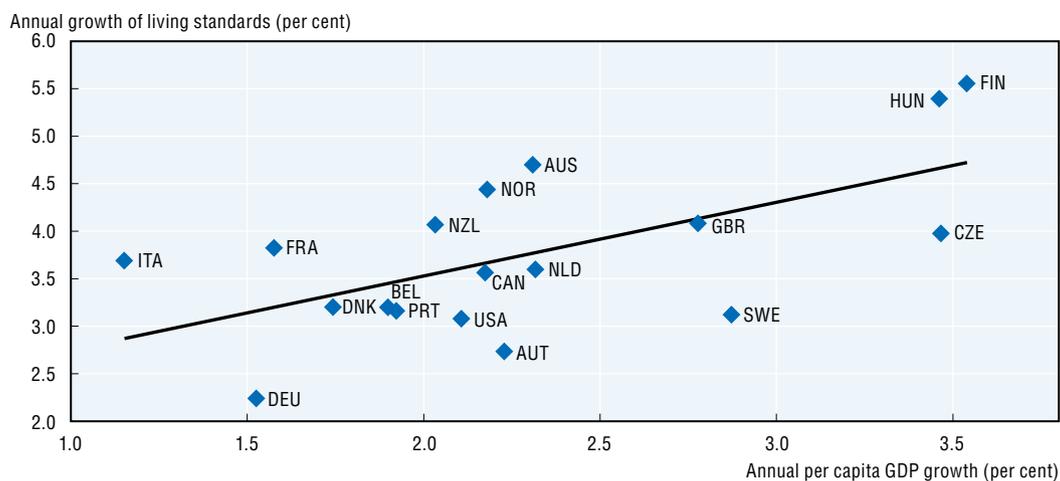
Source: OECD calculations based on OECD Annual National Accounts, OECD Income Distribution Database and OECD Health Database.

Countries with higher GDP are not necessarily the best at converting their wealth into improvement in living standards for their citizens. Indeed, the cross-country correlation between growth rates of GDP per capita and multidimensional living standards is positive but with large variance across countries.⁸ In particular, only 38% of the variance in cross-country changes in multidimensional living standards can be statistically explained by GDP growth. For example, France and Germany have registered almost the same per capita GDP growth during 1995-2007, but living standards grew 1.7 times faster in France (Figure 3.5). Moreover, some countries switch positions when moving away from GDP towards multidimensional living standards. For instance, economic growth has been 2.5 times faster in Sweden than in Italy, but growth in multidimensional living standards has been about 20% less in Sweden. One element that shapes these differences is the divergence between GDP growth and the growth of average household income, influenced by structural factors such as the fiscal stance or the respective roles of the private and public sector.

The contribution of changes in inequality to changes in multidimensional living standards reflects the degree to which the target group's (equivalent) income growth deviates from average (equivalent) income growth. This is somewhat different from stating that rising inequality *as such* drags down multidimensional living standards. Take, for instance, a situation where the income of the target group (say, the median household) remains unchanged between two periods and only the income of the lowest decile increases. This would translate into an unchanged overall measure of multidimensional living standards, driven by two offsetting effects: a positive effect due to the rise in average income (as low-income households earn more with everyone else's income unchanged) and a negative "inequality" effect, because median households did not benefit from the increase in average income. Yet, an overall measure of inequality, such as the Gini coefficient, would show a decline in inequality.

Figure 3.5. **Growth in multidimensional living standards in OECD countries was faster than growth in per capita GDP before the crisis**

1995-2007



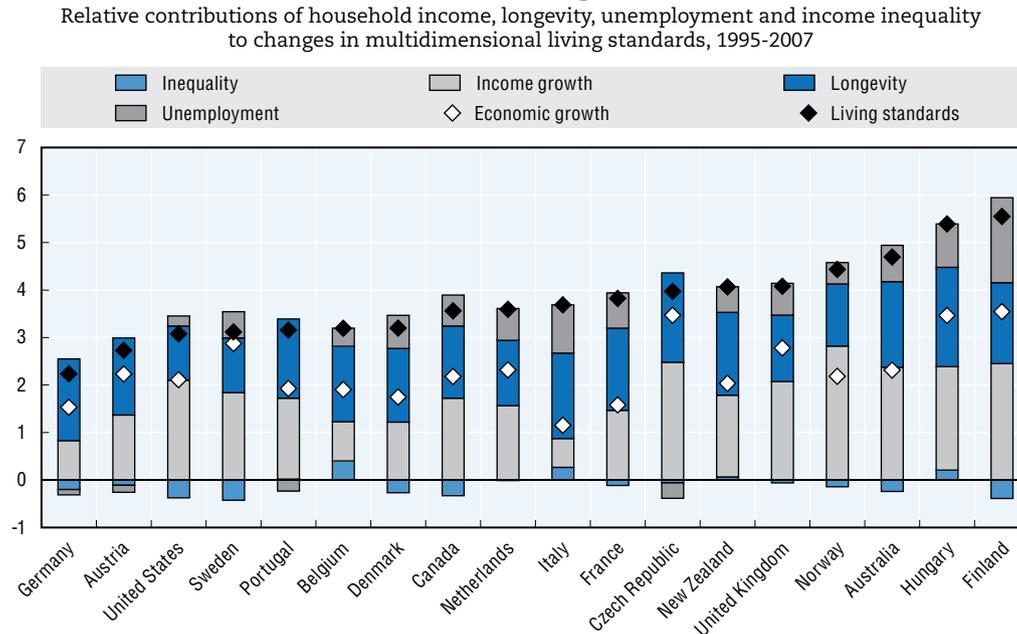
Note: Calculations correspond to the median household income.

Source: OECD calculations based on OECD Annual National Accounts, OECD Income Distribution Database and OECD Health Database.

Furthermore, the contributions of household income, longevity, unemployment and income inequality to growth in multidimensional living standards vary across countries. For example, Germany and Austria display lower growth of multidimensional living standards than France and Australia, because the contributions of household income and employment were relatively lower over that period (Figure 3.6). Australia and Finland are the two countries that display both stronger growth in multidimensional living standards and income relative to OECD averages, combining strong household income growth with large gains in longevity (Australia) and reductions in unemployment (Finland). Conversely, Germany experienced slow household income growth and an increase in income inequality, which jointly explain a significantly lower improvement in multidimensional living standards during 1995-2007. Unemployment did not fall in four countries (Austria, Germany, Czech Republic, Portugal), and only in four countries did income disparities narrow (Belgium, Hungary, Italy, New Zealand). Multidimensional living standards have increased relatively more where they were initially lower. The convergence in multidimensional living standards has been driven by convergence in the underlying dimensions, namely incomes, unemployment, income inequality, and to a lesser extent, longevity. Overall, before the

crisis, multidimensional living standards (a combined measure of median and real household income, life expectancy and jobs) grew faster than GDP per capita in most OECD countries due to falling unemployment and rising longevity. This is despite rising income inequality in some countries, which had a negative effect on growth in multidimensional living standards.

Figure 3.6. **Growth in GDP per capita and in multidimensional living standards often diverge**



Note: Calculations correspond to the median household income.

Source: OECD calculations based on OECD Annual National Accounts, OECD Income Distribution Database and OECD Health Database.

The drivers of multidimensional living standards also vary for different segments of the income distribution. To illustrate these diverse outcomes, multidimensional living standards can be calculated for three different representative equivalent income references: average income, median income and income close to the lowest decile (Table 3.1). When applied to OECD countries over the period 1995-2007, calculations show the rise in multidimensional living standards was somewhat weaker for median households (those with income at the middle of the distribution) and for the poor (those households with income at the lowest decile of the distribution), at 3.8% and 3.6%, respectively, than for the “average” (mean) household. These findings show that widening income inequality affected the poorest households most adversely.

Since the economic crisis, the evolution of multidimensional living standards has taken a different turn, a fact also borne out by the work of Jorgenson and Slesnick. Analysis for 30 OECD countries between 2007 and 2011, or the latest year available, shows that, on (unweighted) average, multidimensional living standards fell by 0.5% per year, with 15 countries witnessing negative growth and 5 countries (Spain, Estonia, Ireland, United States and Mexico) experiencing a fall in multidimensional living standards of more than 5% annually (Figure 3.7). The bulk of the average loss in multidimensional living standards is explained by rising unemployment, while household income remained broadly stable, except in a few countries (Estonia, Greece, Hungary, Italy, Mexico, Switzerland, United States).

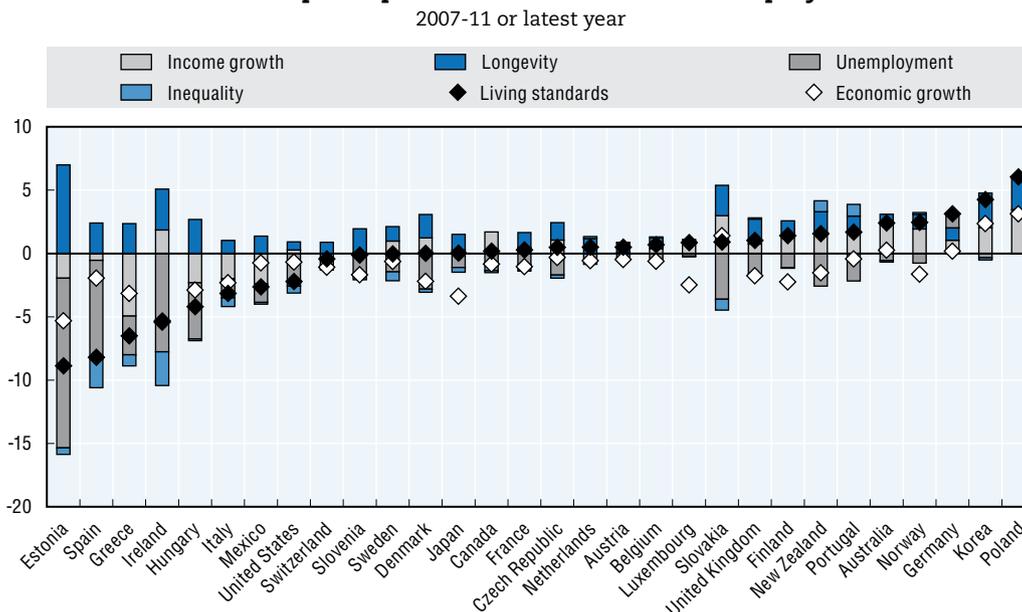
Table 3.1. **Growth in multidimensional living standards varies considerably across social groups**

LIVING STANDARDS ACROSS COUNTRIES 2009				ECONOMIC GROWTH 1995-2007	GROWTH OF LIVING STANDARDS 1995-2007								
Inequality's negative contribution to living standards as a share of disposable household income (2009, in percentage points)				Per capita GDP growth, in percentage points	Living standards contributions of annualised growth in: (1995-2007, in percentage points)						Growth of living standards (1995-2007, in percentage points)		
Income reference:	Average (tau = 0)	Median (tau = 1.5)	Bottom decile (tau = 50)		Average household income	Longevity	Unemployment	Inequality ¹			Average (tau = 0)	Median (tau = 1.5)	Bottom decile (tau = 50)
				Average (tau = 0)				Median (tau = 1.5)	Bottom decile (tau = 50)				
AUS	0.0	19.8	58.7	2.3	2.4	1.8	0.8	0.0	-0.2	-0.4	4.9	4.7	4.6
AUT	0.0	11.9	46.1	2.2	1.4	1.6	-0.2	0.0	-0.1	0.3	2.8	2.7	3.1
BEL	-0.0	11.0	43.7	1.9	0.8	1.6	0.4	0.0	0.4	2.6	2.8	3.2	5.4
CAN	-0.0	16.7	52.9	2.2	1.7	1.5	0.6	0.0	-0.3	-0.7	3.9	3.6	3.2
CHE	-0.0	16.8	58.0										
CZE	0.0	8.5	35.2	3.5	2.5	1.9	-0.3	0.0	-0.1	-0.5	4.0	4.0	3.5
DEU	0.0	12.7	45.4	1.5	0.8	1.7	-0.1	0.0	-0.2	-0.4	2.4	2.2	2.1
DNK	0.0	8.8	39.8	1.7	1.2	1.6	0.7	0.0	-0.3	-0.9	3.5	3.2	2.6
ESP	-0.0	18.4	52.8										
EST	0.0	9.1	29.4										
FIN	0.0	10.0	41.2	3.5	2.4	1.7	1.8	0.0	-0.4	-1.4	5.9	5.6	4.6
FRA	0.0	13.5	47.3	1.6	1.5	1.7	0.7	0.0	-0.1	-0.2	3.9	3.8	3.7
GBR	-0.0	17.9	52.3	2.8	2.1	1.4	0.7	0.0	-0.1	-0.7	4.1	4.1	3.5
GRC	-0.0	16.7	50.6										
HUN	-0.0	7.2	27.6	3.5	2.2	2.1	0.9	0.0	0.2	0.3	5.2	5.4	5.5
IRL	-0.0	15.2	46.3										
ITA	-0.0	17.6	57.3	1.2	0.6	1.8	1.0	0.0	0.3	1.4	3.4	3.7	4.8
JPN	0.0	23.6	69.1										
KOR	-0.0	19.8	62.1										
LUX	0.0	12.5	46.3										
MEX	0.0	27.1	53.1										
NLD	0.0	14.1	52.0	2.3	1.6	1.4	0.7	0.0	-0.0	-0.3	3.6	3.6	3.3
NOR	0.0	11.9	53.0	2.2	2.8	1.3	0.5	0.0	-0.1	-0.6	4.6	4.4	3.9
NZL	-0.0	16.6	52.7	2.0	1.7	1.7	0.5	0.0	0.1	0.4	4.0	4.1	4.4
POL	-0.0	10.8	36.3										
PRT	-0.0	15.1	44.2	1.9	1.7	1.7	-0.2	0.0	0.0	0.3	3.1	3.2	3.4
SVK	-0.0	7.0	28.5										
SVN	0.0	9.8	42.4										
SWE	0.0	12.6	49.5	2.9	1.8	1.2	0.6	0.0	-0.4	-1.7	3.5	3.1	1.9
USA	0.0	19.8	50.0	2.1	2.1	1.1	0.2	0.0	-0.4	-1.3	3.5	3.1	2.2
Average	0.0	14.4	47.5	2.3	1.7	1.6	0.5	0.0	-0.1	-0.2	3.9	3.8	3.6

Note: Based on disposable income only. Income distribution measures rely on surveys and comparability with national accounts income data is incomplete.

Source: Authors' calculations.

Figure 3.7. **During the economic crisis, multidimensional living standards fell faster than GDP per capita in countries when unemployment rose**



Note: Calculations correspond to the median household income.

Source: OECD calculations based on OECD Annual National Accounts, OECD Income Distribution Database and OECD Health Database.

3.5. Linking policies to multidimensional living standards

Measuring multidimensional living standards is a necessary first step towards providing policy analysis and advice for Inclusive Growth. The different dimensions of well-being are driven by a combination of policy and non-policy factors. GDP per capita is affected by pro-growth policies, and also by other influences, which can be exogenous, such as geography, or endogenous, such as good health or education. Similarly, health outcomes are influenced by health policies and also indirect factors, such as income and lifestyle, suggesting that there may be feedback linkages between different outcomes. The way resources are distributed can also affect equality of opportunities to participate in the production process and potentially average outcomes.

Interactions between policies and outcomes in both income and non-income dimensions are complex and important. For example, growth-oriented policies can affect the distribution of income, wealth or consumption; fiscal policies may affect environmental, health and education outcomes; higher public health spending can have potentially positive effects on employment and incomes, but it will also imply higher taxation and hence less material consumption. Such effects have been analysed in OECD work, but they have been considered either as unintended consequences of growth policies or as policy issues in their own right,⁹ without taking an integrated analytical and policy perspective. Recent OECD work has started to address these shortcomings by analysing the trade-offs among growth, equity and social preferences when pursuing fiscal consolidation (OECD, 2013a). The ambition of the policy framework for Inclusive Growth is to bring these dimensions together in a coherent manner, where measurement, analysis and policy advice all keep an ultimate objective in sight: improving multidimensional living standards.

Against this background, the Policy Framework for Inclusive Growth pursues the following objectives. First, it should provide a clear link between individual dimensions of well-being and policies through both direct and indirect channels. Second, it should make explicit the main policy trade-offs and synergies so that policy makers can be better informed about relevant policy choices with respect to the different dimensions of multidimensional living standard. Finally, the Framework should be sufficiently flexible to be adapted to country-specific challenges and circumstances.

Analyzing the impact of policies on Inclusive Growth

For the Framework to be both policy-oriented and evidenced-based, a number of criteria or constraints need to be considered. In particular:

- An *understanding* of the key drivers of the outcomes included in the social welfare function is critically important.
- An *identification* of robust empirical relationships between multidimensional living standards and policies is crucial for interpreting the effects of changes in policy on outcomes.
- The *responsiveness* of outcomes to policy intervention should affect the choice of variables.

The complexity of the interactions between policies and outcomes, together with data limitations, restrict the choices available. In this section, and for illustrative purposes, the analytical framework used to link outcomes to policies focuses only on income and health. Income contributes to material living standards, while health (measured in terms of life expectancy at birth) contributes to quality of life. The choice of these two dimensions is for illustrative purposes only, and an explicit link to policies can be provided not only for the jobs dimension (employment or unemployment), as discussed above, but to other dimensions as well.

The measure of income

Typically, growth-oriented policy analysis focuses on average per capita GDP as the variable of interest. For instance, OECD analysis provides country-specific recommendations on policies that would increase the long-run level of GDP per capita, analysed through a set of sub-indicators. The advantage of using per capita GDP is that it is widely available across countries and over time, and there is much empirical research linking policies and non-policy parameters to GDP. More recent OECD work (OECD, 2013a) has started to look at side-effects of pro-growth policies on income inequality and the environment, but without any attempts to consolidate the aggregate welfare effects or to model potential inter-linkages between these different dimensions. In addition, in OECD (2011a), the focus has instead been on identifying policies and other drivers of shifts in the distribution of income in OECD countries.

From an Inclusive Growth perspective, household income is a more appropriate variable, as discussed above, and the use of GDP per capita as a proxy is unsatisfactory. For instance, as mentioned in Chapter 2, the widening gap between GDP and average household income observed in many OECD countries¹⁰ suggests that even as a proxy for mean living standards, GDP falls short of representing the concerns of the typical individual or household (Atkinson, 2011). Indeed, giving more prominence to household disposable income as opposed to GDP per capita was one of the main recommendations of the Stiglitz-Sen-Fitoussi Commission (2009). An even more relevant measure would be household “spendable” income, where the National Accounts measure of disposable income is adjusted to remove a number of imputed income components (Atkinson, 2012). The main difficulty is that while the link from policies to per capita GDP is well established,

it is far less obvious when household income is used as a proxy. Also, the traditional growth model and production function cannot be applied directly to household disposable income as this is not well grounded in economic theory.

The approach adopted here consists of looking jointly at the two income concepts and examining the extent to which growth in GDP per capita trickles down and benefits households across different income groups. More specifically, the idea is to investigate whether household incomes – on average and along the distribution – are jointly determined by the same set of structural policies as GDP. Comparing the impact of policies on GDP as well as on household incomes and their underlying distribution may allow for identifying potential policy trade-offs and complementarities with respect to the objective of raising both efficiency and equity. The analysis uses measures of household income following the income standard approach based on the *general means* concept defined in Atkinson (1970)¹¹ as developed in Foster and Szekely (2008) (Box 3.5).

Policy interactions are potentially complex even in a simple case where aggregate living standards are defined over two dimensions. This creates scope for similar policy instruments to influence living standards through multiple, sometimes offsetting, channels (Box 3.7). For instance, growth-oriented policies that successfully raise the income of the majority of households will at the same time benefit life expectancy through higher spending on health, but such benefits may be offset, as noted earlier, if growth entails severe air or water pollution. Conversely, environmental policies may result in lower GDP per capita and income but still lead to higher multidimensional living standards through improved health status and life expectancy. Similarly, health spending raises life expectancy at 65 by more than at birth. Hence, unless working life is adjusted in proportion to life expectancy, higher health spending will result in a higher ratio of retirees to the working population, thereby

Box 3.7. From production to income: taking distributional effects into account

In a two dimensional setting, it is important to identify the channels through which policies affect income and health outcomes. Income is defined by household disposable income and health by longevity as in the previous example.

The drivers of incomes

To capture the drivers of income, two alternative sets of equations are considered, which differ according to whether household income is linked directly to GDP or to its main components:

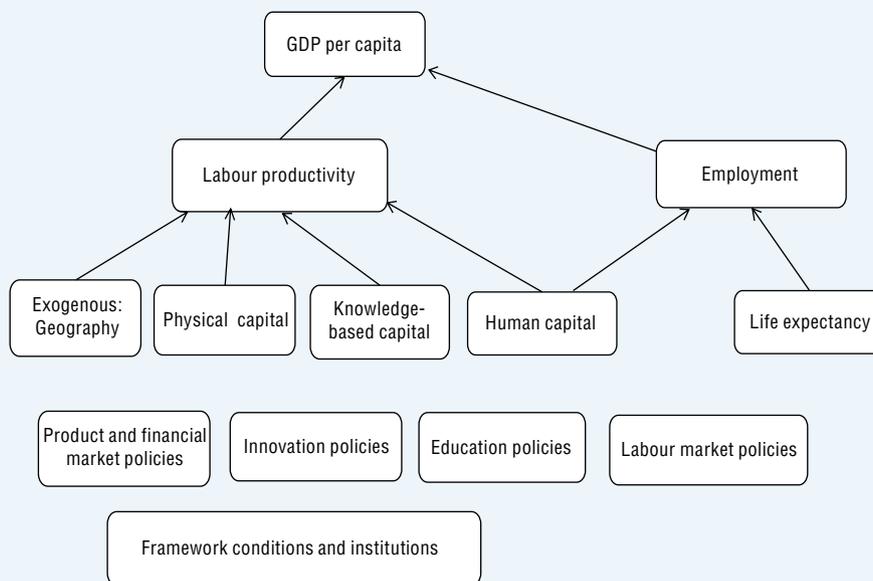
$$\bar{y}_\tau = G[\overline{gdp}, q_y, z_\mu], \quad (1)$$

$$\bar{y}_\tau = H[k, h, mfp, empl, q_y, z_\mu], \quad (1)'$$

where \bar{y}_τ is generalised average household disposable income that varies according to the weight put on different segments of the distribution, as mentioned above; \overline{gdp} , k , h , mfp and $empl$ denote, respectively, average GDP, physical capital, the stock of human capital, multifactor productivity and the ratio of employment to working-age population; z_y denotes exogenous factors such as geography; and q_y is a vector of policies influencing directly GDP per capita after controlling for inputs. z_μ captures non-policy factors, such as corporate savings, and which can drive a wedge between GDP per capita and household incomes over a prolonged period; q_y is introduced in both cases to allow for the possibility that a number of policies may have a significant impact on household income over and above their indirect effect through GDP (1) or its main determinants (1)'. Per capita GDP itself is of course determined by several policy and non-policy variables, best summarised in Figure 3.8.

Box 3.7. From production to income: taking distributional effects into account (cont.)

Figure 3.8. The link between policies, inputs and income



The drivers of life expectancy

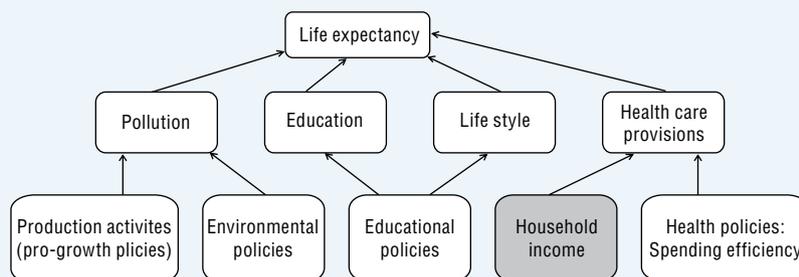
Life expectancy is affected by health policies, but also pollution, lifestyle, education and incomes. The relationships are complex: higher incomes permit more health spending but also give rise to more pollution; education results in better use of health services and also higher incomes (Figure 2.9). Other factors, not taken into account explicitly here, include poverty, social exclusion, job discrimination and job insecurity. Insofar as they correlate with income inequality, they are captured in the proposed framework, in which life expectancy is modelled as:

$$\overline{LE} = F(\overline{y}, env, h, q_{LE}, z_{LE}), \tag{2} \text{ and:}$$

$$env = F(\overline{gdp}, q_{env}, z_{env}), \tag{2a}$$

where *env* captures the effect of pollution, q_{LE} is a vector of policies which, in addition to (public) spending on health care, includes ideally factors affecting the efficiency of health care delivery and other potential longevity-enhancing policies; z_{LE} denotes a vector of factors linked to the lifestyle (e.g. smoking, alcohol consumption and dietary habits), and which although they can be influenced by policies are treated as exogenous in this framework. q_{env} and z_{env} are vectors of environmental policies and exogenous factors causing pollution, respectively.

Figure 3.9. The link between policies, non-policy inputs and life-expectancy



lowering employment rates and GDP per capita. Finally, increasing health spending may have indirect but hard-to-estimate effects on GDP, for instance through lower sick leave and disability (increasing average hours and therefore GDP per capita) or higher tax rates (lowering employment rates and therefore GDP per capita).

An empirical model can be used for the joint estimation of GDP per capita and household income equations (Box 3.8). The long-run determinants of GDP are human and physical capital, labour-augmenting efficiency (captured by a time trend) and population growth. Household disposable income is measured on the basis of general means. Its specification assumes that in the long run the level of income is mainly driven by the level of GDP per capita and includes a proxy for terms of-trade fluctuations and country-fixed effects¹², and country-specific time trends to control for potential distortions due to data limitations such as the under-reporting of top incomes (in particular the top one per cent) and the non-inclusion of capital gains as a source of incomes.¹³ To obtain a preliminary assessment of the distributional effects of structural policies, the specification for household disposable

Box 3.8. The baseline model: Structural econometric modelling of GDP and household incomes across the distribution

The baseline specification takes the following form:

$$\Delta \ln(\text{GDPT}) = \beta_0 - \beta_1 \ln(\text{GDPT} - 1) + \beta_2 \ln(st) + \beta_3 \ln(ht) - \beta_4 nt + \beta_5 t + \delta_1 \Delta \ln(st) + \delta_2 \Delta \ln(ht) + \delta_3 \Delta \ln(nt) + \varepsilon$$

$$\Delta \ln(\mu_\alpha(xt)) = \eta_{0,\alpha} + \eta_1 \alpha \ln(TTt) + \eta_2 \alpha \Delta \ln(\text{GDPT}) + \eta_3 \alpha \ln(\text{GDPT}) - \eta_4 \alpha \mu_\alpha(xt - 1) + \nu$$

with $\text{cov}(\varepsilon, \nu) \neq 0$ and where:

- $\Delta \ln(\text{GDPT})$ is the variation in GDP per capita between year t and year $t - 1$
- $\Delta \mu_\alpha(xt)$ is the variation in income standards between year t and year $t - 1$ for a given value of α , i.e. the parameter driving the emphasis on different parts of the income distribution. The baseline specification covers the entire income distribution as measured by top to bottom-sensitive income standards. Household income equations are therefore estimated for a continuous range of α s.
- s is the investment rate defined as the share of investment in productive capital over GDP
- h is the stock of human capital, measured as mean years of schooling
- n is the growth rate of the working age population
- TT measures terms of trade effects (i.e. changes in export relative to import prices). Terms of trade effects are accounted for in consumer price deflators but not in GDP deflators. This variable is included as a control for one of the known and measurable sources of discrepancies between developments in GDP per capita and in household disposable incomes. See Causa, O. et al. (2014) for recent evidence.
- ε et ν are error terms, assumed to be correlated across the two equations

These equations are estimated jointly by Seemingly Unrelated Regression Estimation (SURE) procedures. The GDP per capita and household income equations include country fixed-effects. The GDP per capita equation systematically includes a time trend and country specific time-trends. The baseline analysis is presented under two variants defined by a differential treatment of time in the household income equations: i) the household incomes equations are first estimated without and then ii) with time trends and country specific time-trends.

In the baseline setting, the parameters of interest are $\eta_{3,\alpha} / \eta_{4,\alpha}$ and measure the household disposable incomes elasticity to GDP per capita for: i) average household income ($\alpha = 1$) and ii) household incomes at different points of the distribution, as measured by top to bottom-sensitive income standards ($\alpha \neq 1$). The comparison of GDP per capita elasticities across α allows for assessing the distributional effects of GDP per capita growth.

The baseline estimations cover all OECD countries over the period from mid-80 s to late 2000s.

to depend on whether the reform affects all unemployed workers or is targeted to the long-term unemployed:

- Untargeted reductions in replacement rates are found to raise GDP per capita and even more so household disposable incomes, by similar amounts across different points of the distribution. This suggests that in the long run, employment gains¹⁶ largely offset income losses from reduced transfers and increased wage dispersion, implying that unemployment benefit reforms could help boost incomes without widening inequality.
- Reductions in replacement rates targeted to the long-term unemployed (i.e. benefits for jobseekers in the fourth and fifth year of unemployment) are found to increase disposable incomes for the median household but to reduce disposable incomes for the lower-middle class and, even more, poor households – unambiguously pointing to higher inequality.
- These differential distributional implications imply that targeting unemployment benefit reforms to the long-term unemployed may deliver relatively less employment gains because the long-term unemployed have usually lower chances to find a job relative to the recently unemployed, reflecting compositional effects as well as skills erosion.

The macroeconomic effects of ALMPs are difficult to identify empirically, but these policies have strong distributional consequences.¹⁷ In fact, the empirical evidence reported above fail to identify a significant effect on GDP per capita, although there appear to be significant positive effects on average household incomes. This finding holds for household incomes down the distribution and associated income gains are found to be larger for the poor, pointing to equalising effects. This tentatively indicates that stepping up job-search support and programmes for the unemployed can increase jobseekers' employment chances and wages once in employment and, via this channel, reduce income inequality.

Empirical evidence on selected drivers of globalisation

There is fairly strong empirical evidence of the growth-enhancing consequences of globalisation, especially in mature economies, but this is far less the case about its distributional implications. The empirical evidence reported below shows that globalisation-related inequality effects are mainly driven by the wage dispersion channel, in particular arising from changes in the skill and industry composition of labour demand.¹⁸ To shed light on these effects, the joint effects of export intensity, as well as FDI inflows and outflows on GDP per capita, and the four measures of household disposable incomes have been examined, using the same framework as for labour market policies.¹⁹ The main results are presented in Table 3.3.

Stronger export intensity boosts long-run GDP per capita and average household disposable income. Such effects hold across the distribution of household income, but with significantly stronger estimated gains for the poor. The stronger positive effects of export intensity on lower income households are broadly consistent with previous empirical literature (e.g. Jaumotte et al., 2008, and Koske et al., 2012), pointing to the positive effects of international competition on GDP and employment.²⁰

The results on the impact of international financial integration through FDI flows are less clear-cut. In particular:

- The influence of inward FDI is qualitatively close to that of export intensity, a likely reflection of the interplay between trade and FDI, and the resulting difficulty to identify their isolated effects: there is evidence of positive effects on GDP per capita and positive equalising (both indirect and direct) effects on household disposable incomes. This suggests that policy reforms aimed at easing barriers to entry for foreign firms could both raise efficiency and incomes of the less-well off.

Table 3.3. **The effects of globalisation on GDP per capita and household disposable incomes across the distribution**

	Export intensity				FDI inflow				FDI outflow			
	GDP		Total effect	Direct effect	GDP		Total effect	Direct effect	GDP	Total effect	Direct effect	
Average income	+	**	+	***	+	***	+	***	ns			
Bottom-sensitive income standards												
Median income			(+ =)	***			(+ =)	***			-	**
Income of the lower middle class			(+ =)	*	+	**	(+ >)	***	+	*	-	**
Income of the poor			(+ >)	**	(+ >)	**	(+ >)	***	(+ =)	*	(- <)	***

Note: The entries of this table come from the estimation of the simultaneous effects of policies on long-term levels of GDP and household incomes across the distribution. Since GDP per capita is a determinant of household incomes across the distribution, the total effects of policies on the latter decompose as follows: i) indirect effects, i.e. channelled via reform-driven GDP effects and ii) direct (or additional) effects, i.e. over and above GDP effects. The tables systematically report: i) the effects of structural policies on GDP per capita, which, by construction imply equivalent indirect effects on household incomes; ii) the total (or net) effects of structural policies on household incomes, combining direct and indirect effects; iii) the direct (or additional) effects of structural policies on household incomes. The policy indicators are entered in lagged levels in both the GDP and the household income equations.

The entries can be read as follows. + denotes a positive policy impact while - denotes a negative one. The table also provides (statistical) comparison of estimated policy effects on household income standards at different points of the distribution, respectively the median, the lower-middle class and the poor, with policy effects on average household income. Hence, the cases >, < and = denote, respectively, a positive impact of the reform which is, for a given income group, statistically higher, lower, or equal than that on average income. For example, in the case of unemployment benefit replacement rate (summary measure of generosity), household income effects are negative for all income groups and they are more negative for median income, incomes of the lower middle class and incomes of the poor, in each case compared with average income. The symbols (*, **, ***) denote respectively statistical significance at 10, 5 and 1% t level.

- The impact of outward FDI is insignificant on both GDP per capita and average household income. By contrast, there is some evidence of negative effects on household incomes of the lower-middle class and the poor. These effects are consistent with the outsourcing hypothesis.

Summing up

Preliminary empirical evidence on the effects of a set of stylised structural reforms on GDP per capita and household disposable income at different segments of the distribution illustrates the scope for using the Inclusive Growth Policy Framework to identify policy synergies and trade-offs. Indeed, some pro-growth policies that are associated with higher GDP per capita and/or average household disposable incomes in the long term can have less beneficial impacts on the incomes of households at the lower end of the distribution. This would be the case of reductions of support benefits for the long-term unemployed and of policies that favour FDI outflows. In both cases, the results point to a decline in the income of poorer households, even as the average household income increases. However, the analysis also points to combination of reforms that would mitigate or offset these effects. For instance, reforms of unemployment benefits would be best considered in a context where activation policies are stepped up. Likewise, the adverse effects of FDI outflows may not materialise if measures are taken to encourage stronger inward investment.

Notes

1. In 1970, nearly 30% of the OECD labour force was employed in manufacturing. By the end of the century, this had fallen to under 20%. Over the same period, employment in services rose from less than half to two thirds of the labour force (OECD, 2001).

2. Financial deepening is a rise in the volume of financial transactions relative to the real economy. Extensive research about the link between financial deepening and inequality has been conducted. Levine (2005) positively linked financial development to growth and equity in a sample of mainly developing countries; in the same vein, a study on Thailand conducted by Hamori and Hashiguchi (2012) associates financial deepening with greater equity. Overall, financial deepening is associated with higher growth, but disproportionately benefits high-income groups. The accessibility of the financial sector is important in measuring growth from financial deepening (IMF, 2008).
3. United Nations (2013), *The Millennium Development Goals Report*, United Nations, New York. "Developing regions have made impressive strides in expanding access to primary education, with the adjusted net enrolment rate growing from 83 per cent in 2000 to 90 per cent in 2011." Almost half the reduction in the global number of children out of school can be attributed to Southern Asia. Youth and adults both have made steady progress in literacy over the last two decades.
4. On average, social expenditures represent almost 15% of GDP of lower middle income countries. Except some cases, such as Mongolia that provides universal children benefits, Asian country stand below this average, ranging from 4,4% in Laos to 12.5% in Indonesia.
5. Empirical work on the determinants of subjective well-being shows that the income-related variables, unemployment and health are highly significant (Boarini et al., 2012; OECD, 2013a).
6. For instance, one year in life expectancy was gained in 5 years in the United States versus 3 years in Ireland, two countries with identical life expectancy in 1995. More generally, the rate of progress varies between 8.2 years (Mexico) and 1.9 years (Estonia) per additional year of life expectancy, with an average of 3.9 years and a standard deviation of 1.1 year. When excluding ten emerging or transition countries, the average is identical but the standard deviation is still equal to 0.7 years. Sen (1998) notes that "[...] mortality rates can shift very quickly indeed when it moves in an upward direction due to an economic crisis. Famines provide a class of examples in which the movement of mortality can be disastrously rapid, and they certainly do call for immediate economic response. But there are also examples of other kind of economic and social change in which mortality rates have gone up extremely fast. The recent experience of the former Soviet Union and of Eastern Europe provides many such terribly distressing cases."
7. Health has the largest impact (about 17% of disposable income), followed by inequality (15%) and unemployment (13%). Inequality is measured through the distribution of household disposable income across deciles. It is therefore not a comprehensive measure of inequality that would also capture the distribution of non-material components. This shortcoming reflects data constraints.
8. This is also a finding by Beal, Rueder-Sabater and Espirito-Santo (2012) who construct measures of well-being that cover 10 different dimensions and 150 countries. "... countries with higher GDP are not necessarily the best at converting their wealth into well-being for their citizens."
9. See for instance OECD (2018) and OECD (2011a).
10. Reasons for the gap between per capita GDP and average household incomes include the increasing share of profits in national income, and their retention by corporations, or their eventual distribution in the form of capital gains.
11. In Foster and Szekely (2008), the income standard is defined as a "function that summarises the entire distribution in a single income level that indicates the general affluence of the distribution or the affluence of some part of the distribution".
12. A previous study showed that the contribution of terms-of-trade fluctuations to the gap between real GDP per capita and average household disposable income was particularly large in commodity-exporting countries, and that it could also be significant elsewhere (Causa et al., 2014).
13. The trend rise in the profit share of GDP per capita would imply that associated income transfers from the corporate to the household sector increase for shareholders – generally households in the upper-end of the income distribution. In turn, an increase in the portion of profits that is distributed through capital gains (re-invested profits, share buy-backs, etc.) means that a growing share of household income is under-reported due to the treatment of capital gains.
14. These levels are obtained from selecting four values for the parameter in the equation of Box 3.5.
15. See OECD (2011a) and Koske et al (2012).
16. For evidence on employment effects see e.g. Nunziata, (2002), Bassanini and Duval (2006), de Serres and Murtin (2013), Nickel et al. (2005), and OECD (2011a).

17. See Kluge (2010) for a survey on the effectiveness of ALMPs to improve labour market performance. Vanhoutt (1997) provides some evidence on inequality-reducing effects from higher spending on ALMPs.
18. See OECD (2011a) for references.
19. The measures taken are based on previous OECD work (OECD, 2011a) and accordingly the estimation is done by controlling for concomitant structural shifts affecting the composition of OECD economies, e.g. in terms of the sectoral (agriculture, industry and services) as well as the share of women in total employment.
20. In the latter case the paper measures overall trade as a share of GDP and does not disentangle imports and exports effects.

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Chapter 4

Mainstreaming inclusive growth into policy making

What can be done about rising inequalities? How can policy programmes be combined to promote more Inclusive Growth that enhances well-being and raises living standards for all citizens? This chapter explores structural policies geared towards both raising the long-term growth potential of economies and making that growth more inclusive. The recommendations laid out pay particular attention to instruments in the following areas: fiscal and monetary policies, labour markets, education, competition and regulation, innovation and entrepreneurship, finance, infrastructure and public services, urbanisation, and development. The chapter sets out to consider how particular policies can be combined to foster synergies, and deal with trade-offs, between growth and equity objectives.

The previous chapters have shown that, regardless of how it is measured, inequality of incomes is on the rise in most OECD countries, and that it is even higher, on average, in developing countries and emerging economies. Low incomes are associated not only with low material standards of living, but also with poorer health, shorter lives, less education, weaker attachment to the labour market, and lower levels of integration into society at all levels, all of which tend to persist across generations. Despite decades of social policies aimed, with some undeniable success, at narrowing the gaps in outcomes between the disadvantaged and the advantaged, it has become clear that more avenues need to be explored, because high and/or growing inequality pose a threat to both social harmony and to economic growth itself.

Building on the trends described in Chapter 2 and the key elements of the Framework presented in Chapter 3, this chapter discusses the main policy areas that could be part of national Inclusive Growth strategies. Emphasis is placed on the key policy domains that are known to have a strong positive effect on the long-term growth potential of economies and could at the same time lead to improvements in the non-income outcomes that matter for well-being, as well as a better distribution of these income and non-income outcomes. In addition to the focus on outcomes, policy initiatives are also discussed with a view to improving the distribution of opportunities. The major policy areas reviewed in this chapter are macroeconomic (including tax/benefit systems); labour markets; education; competition and regulation; innovation and entrepreneurship; financial sector; infrastructure and public services; national versus regional versus local issues; and foreign aid and development.

4.1. The macroeconomic underpinnings of Inclusive Growth

Sound macroeconomic policies are a pre-condition for sustained growth, employment and poverty alleviation but can also generate some trade-offs between equity and efficiency. A stable macroeconomic framework makes investment less risky, *ex ante*, contributing to sustainable growth and job creation. There is however a trade-off between efficiency and equity in this context: higher investment leads to higher productivity and *higher wages* than would otherwise be the case, but higher investment and capital intensity can also result in *higher income shares* for the owners of capital. Low inflation, which characterises a predictable macroeconomic environment, also encourages investment, which is essential for growth, and preserves the real value of income, which is important for social groups with limited access to financial services and products. Moreover, low budget deficits and government indebtedness are known to create a favourable environment for growth and could make the fiscal policy stance more redistributive by creating room in the budget for higher spending on social services and protection. Macroeconomic policies that prevent a build-up of external imbalances also avoid corrective swings in exchange rates that can be detrimental to vulnerable social groups.

Adverse distributional effects from macroeconomic instability are likely to be strong in developing and emerging market economies. Income losses arising from high inflation are likely to be greater where financial markets are shallower, and many households, especially poorer ones, have no or only limited access to financial services (Prasad, 2013). In those countries, many workers are in the informal sector and have no entitlement to unemployment insurance and formal social safety nets that could cushion the effects of job losses arising from adverse macroeconomic shocks. An economic downturn can thus be financially catastrophic for many households, possibly with long-lasting effects.

Monetary policies and their impact on income distribution

Monetary policy affects the distribution of income. In many countries, monetary policy is conducted within an inflation targeting framework and focuses primarily on price stability. In some cases, central banks also pursue other targets, de facto or de jure, such as financial stability and exchange rate stability, and other indicators, such as the unemployment rate, are being used as intermediate targets where forward guidance is used as part of the monetary authority's toolkit. However, changes in the monetary stance alter the relative prices of financial assets, shifting income between debtors and creditors and the net holders of different financial assets, thus impacting on the overall income distribution.

A stability-oriented monetary policy cushions the impact of negative shocks on poorer households. As noted above, inflation has a direct effect on the distribution of income through changes in the real value of assets. An unexpected increase in inflation hurts savers and benefits borrowers. Inflation hurts in particular richer and older households, as they hold a larger share of their wealth in financial assets, but it is also particularly harmful to the poorest social groups, who tend to hold a larger proportion of their savings in cash. In addition, monetary policy shocks and surprise inflation can have an impact on inequality through their effect on income from labour and on job losses for less-skilled workers. The negative redistributive impacts of monetary policies will be lower where the monetary authorities succeed in countering macroeconomic cycles, rather than overreacting when they do occur.

Nevertheless, macroeconomic stability does not necessarily ensure improvements in the distribution of income. This was the case during the period known as the "great moderation", when economic growth was steady, but income gains accrued disproportionately to richer households, as discussed in Chapter 2. This was because of a combination of factors, not least financial innovation and rising returns to high skills, which favoured the accumulation of income among top earners, at a time when monetary policy focused on the pursuit of consumer price stability and was unable to prevent an asset-price bubble developing.

Monetary policy in developing and emerging market economies often targets the exchange rate in addition to inflation. Efforts to enhance price competitiveness by targeting an undervalued exchange rate tend to favour firms and workers in the tradable sector to the detriment of those operating in non-traded sectors and consumers in general, who pay higher prices for imported goods. Over time, inflationary pressures tend to build up, poorer households are disproportionately hit, and corrective adjustments in the real exchange rate ultimately shift income back to the non-tradable sector. Financial repression, for example through mandated portfolio allocations for banks, may be used to reduce the cost of sterilised interventions in foreign exchange markets (Prasad, 2013).

The effects of capital controls on the distribution of income need to be better understood. In some countries, controls are introduced on capital inflows in periods of abundant international liquidity to raise the relative cost of foreign investment that could be destabilising in shallow capital markets, and would lead to an appreciation of the domestic currency and a build-up of vulnerabilities. Controls are also introduced on capital outflows to prevent capital flight in periods of financial vulnerability. Although such controls might work in the short term, they can often be circumvented, making their effectiveness short-lived. More importantly, by altering the relative price of domestic and foreign financial assets, capital controls affect the funding costs of firms differently, often to the detriment of smaller enterprises that cannot easily circumvent the controls and rely on more traditional sources of credit.

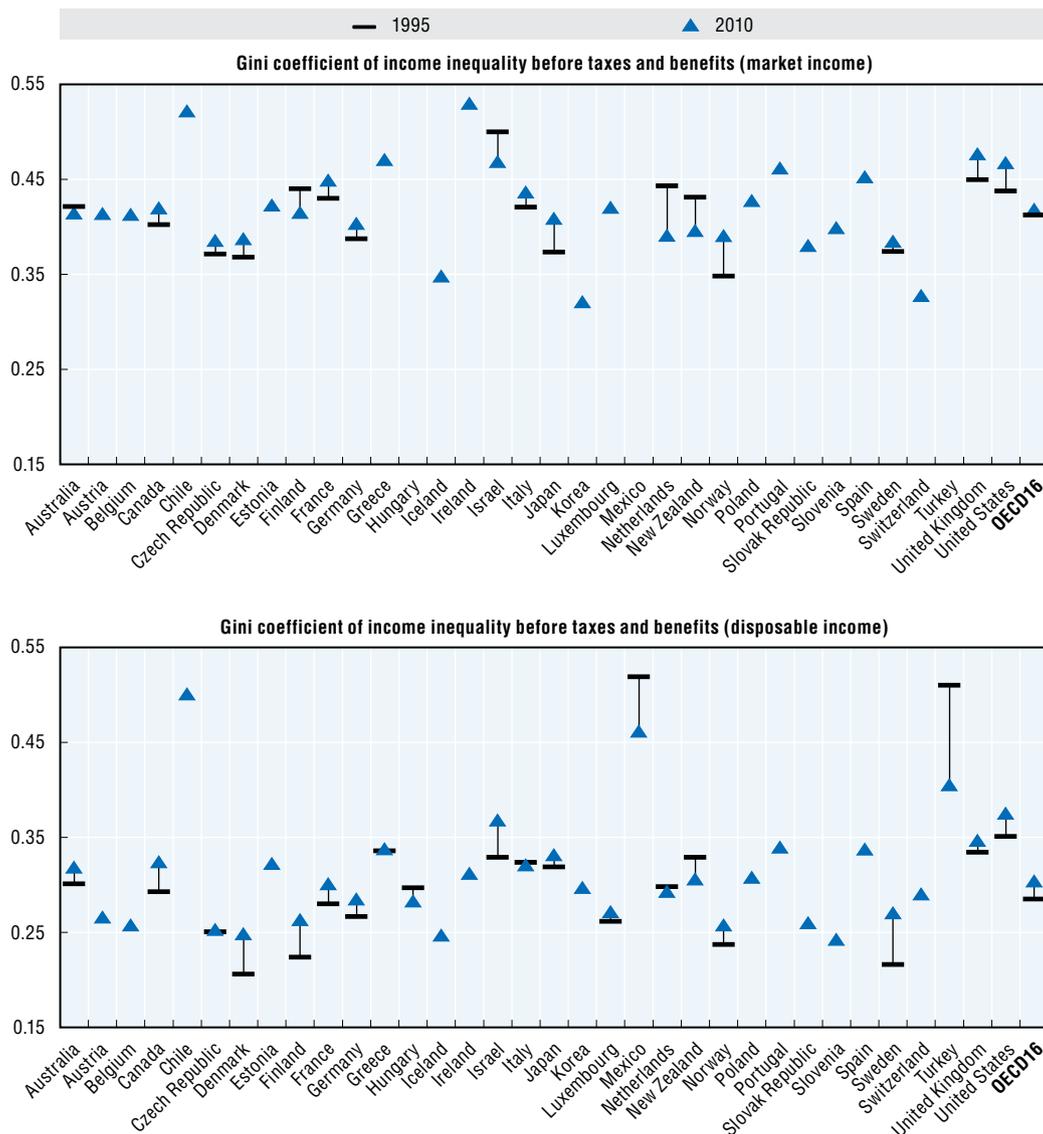
Fiscal policy is relevant to both redistribution and economic stability

Fiscal policy has played a crucial role in mitigating income inequality in advanced economies. This has been achieved essentially through the tax-benefit system, which relies on progressive taxation to finance redistributive transfers to poorer individuals and households, as well as the provision of public goods and services, which creates to varying degrees, depending essentially on programme design and implementation, better opportunities for individuals to participate in economic life. Fiscal policy also plays a crucial role in helping to stabilise the economy over the business cycle, which has a bearing on redistribution, as discussed above.

Although less redistributive than in the past, tax-benefit systems still play an important role in mitigating earnings inequality in OECD countries. In the late 2000s, income inequality among the working-age population was on average 25% lower after taxes and transfers (Figure 4.1) (Joumard, Pisu and Bloch, 2012). The fall in the Gini coefficient before and after taxes and transfers for the whole population is substantial, as much as 0.2 points on average for OECD countries. In practice, about two-thirds of the redistribution has been the result of cash transfers to targeted households in the form of child allowances, public pensions and the like, and one third the result of progressive tax schedules. If in-kind benefits (education, health care and social housing services) are added, the Gini coefficient falls by a further 0.07 points on average for OECD countries (OECD, 2011a). Nevertheless, this substantial equalising effect on net incomes has to be set against a generally rising trend in pre-tax earnings inequality in most OECD countries.

Rising inequality is motivating reform of tax-benefit systems in many countries. In 2013, Greece removed several tax deductions and credits from the personal income tax system, such as for mortgage interest deductibility, and eliminated the tax-free threshold that favours the self-employed (OECD, 2013n). In Indonesia, the government reduced the notoriously regressive fuel subsidy (OECD, 2012f) in June 2013. There is, nevertheless, much room for making tax policy more redistributive and efficient at the same time. For example, in the United States, where the level of income inequalities is among the highest in the OECD, there is a high degree of scope for reducing tax expenditures, which in some cases benefit higher-income individuals and larger firms (OECD, 2012g) (Box 4.1).

Figure 4.1. **Although less redistributive, tax and benefit systems still have a sizeable redistributive impact in OECD countries**



Notes: Data refer to the working-age population. Incomes refer to household equivalised incomes. 1995 refers to 1994 for Greece, United Kingdom and to 1996 for Czech Republic, France, Luxembourg. 2010 refers to 2009 for Japan, New Zealand and Switzerland and to 2011 for Chile.

Source: OECD Income Distribution Database.

Country experiences are instructive. In Colombia, the government introduced a tax reform in 2012 aimed at strengthening the redistributive impact of taxes, promoting formal employment and reducing tax avoidance and evasion. As a result of the reform the poor and middle classes have seen their effective income tax rate fall from 6 to 0%, while a maximum rate finally passed for the richest segment of the population was 15% (the proposal was for 25%) (OECD, 2013m). The 2013 reform of social assistance in Denmark has focused on helping youth with low educational attainment to escape from the inactivity trap (OECD, 2014f). In particular, individuals under the age of 30 are given

financial support to undertake education instead of standard social assistance. In Estonia, the government introduced a means-tested benefit for to help university students from disadvantaged socio-economic background coping with the cost of living while pursuing higher education (OECD, 2012e).

Box 4.1. **Reforming the tax and transfer systems in the US to address rising income inequalities**

Compared with the OECD average, the United States has a significantly higher level of income inequality of over the whole population, and one that has risen faster over time. Whereas real average household market income in the US rose by 34% in the 30 years up to 2009, real median household market income rose by only 14%: indeed, the share of the top quintile increased by 10 percentage points. The inequality of disposable income is now the fourth highest among OECD countries, behind Chile, Mexico and Turkey. After redistribution mechanisms – household taxes and cash transfers – are taken into account, the US also has the fourth highest relative poverty rate among OECD countries, behind Mexico, Israel and Chile. The impact of household taxes on reducing inequality (as measured by the Gini coefficient) is in fact greater than in most OECD countries (the top 1% of tax payers in 2009 paid 22% of federal taxes), but the impact of cash transfers is much lower (Denk et. al. 2013). As in other countries, the distribution of wealth is even more unequal than the distribution of income. It is estimated that the top 1% of households owned 35% of net worth in 2004, and the bottom 40% owned less than 1% (Wolff, 2007). One consequence of the high and rising inequality of both income and wealth, combined with lowered taxes and duties on intergenerational transfers, is that intergenerational social mobility has fallen significantly, and is now lower on several measures than in many European countries (Causa and Johansson, 2009).

The causes of rising inequality are various (Chapter 3), and policies to mitigate it can also vary between countries. In the particular case of the United States, to foster Inclusive Growth, Denk et al. (2013) suggest:

- Direct more resources towards the education of disadvantaged children, and upgrade teachers' salaries to attract more able candidates;
- Raise tax rates on income from capital to discourage the richest households from taking advantage of tax loopholes, without distorting incentives to invest to an unacceptable extent;
- Cap tax expenditure rates on for example mortgage interest deductions or employer-financed health cover to 28%;
- Lower incentives on corporations to move their production abroad to take advantage of lower taxes there;
- Reform social programmes to target the poorest households with means-tested transfers, rather than specific demographic groups.

Protecting the redistributive role of fiscal policies is likely to become more challenging in the years to come. This is because of a number of factors, not least population ageing and the need to maintain fiscal consolidation efforts over the medium term, which will put pressure on national budgets and constrain their ability to redistribute income towards less affluent social groups. At the same time, enhanced mobility across national frontiers for both firms and high-earning individuals continues to put pressure on governments to reduce the tax burden on corporate profits, higher levels of personal income and other mobile tax bases. All of which has made income tax progressively less redistributive, despite international efforts to curb tax evasion, profit shifting and base erosion (Box 4.2).

A full assessment of the distributional effects of consolidation packages would need to consider dynamic measures, such as life-time income distribution and equality of opportunity, along with behavioural responses and interactions with other policies. Increasing direct taxes on incomes would reduce income inequality, while cutting transfers

by the same amount would have a potentially greater and opposite effect. However, raising progressive labour income taxes could have adverse effects on long-run growth, especially in countries where the tax burden on income is already high (Arnold, Brys and Johannsson, 2011). Cuts in government wages and employment can yield fast consolidation gains but need to be accompanied by increases in efficiency of service delivery, for example in the areas of health and education, to avoid reductions in public services hitting vulnerable social groups disproportionately. Cuts in unemployment-related and disability benefits will likely hit poorer people in the first place but may have less adverse effects on inequality in the long run once employment increases in response to a better incentive structure (OECD, 2013f). Those tax expenditures that mainly benefit higher income groups can be reduced, and taxes on immovable property increased. Higher rates of taxes and duties on intergenerational transfers of wealth would not only increase tax revenue, but also make for a more equitable and sustainable distribution of wealth.

Box 4.2. **Combating tax avoidance and evasion**

In an interconnected world, national tax laws have not kept pace with global corporations and fluid capital, leaving gaps that can be exploited by companies who avoid taxation in their home countries by pushing profits abroad to low or no tax jurisdictions. This activity, which is referred to as **base erosion and profit shifting (BEPS)**, undermines the fairness and integrity of tax systems, costs governments money, distorts competition, leads to inefficient allocation of resources, and undermines voluntary compliance by all taxpayers. Because BEPS strategies take advantage of interactions between the tax rules of multiple jurisdictions, only an internationally co-ordinated effort can effectively respond to this issue. At the request of G20 Finance Ministers, in July 2013, the OECD launched an Action Plan on BEPS, identifying 15 specific actions to address this issue in a comprehensive and co-ordinated way, following the core principles of coherence, substance, and transparency. The actions outlined in the plan will be delivered in 2014 and 2015 by the joint OECD/G20 BEPS Project, which involves all OECD members and G20 countries on an equal footing.

Globalisation has also made it easier for all taxpayers to make, hold and manage investments through financial institutions outside of their country of residence. Vast amounts of money are kept offshore and go untaxed to the extent that taxpayers fail to comply with tax obligations in their home jurisdiction. Co-operation between tax administrations is critical in the fight against tax evasion and a key aspect of that co-operation is exchange of information. Responding to a call from the G20 the OECD, working with G20 countries, has developed a single global standard for **automatic exchange of information**. The standard obliges countries and jurisdictions to exchange information obtained from their banks and financial institutions automatically on an annual basis. Further, the OECD is expected to deliver a detailed Commentary on the new standard, as well as technical solutions to implement the actual information exchanges, during a meeting of G20 Finance Ministers in September 2014.

Source: <http://oecd.org/tax/beps.htm> and <http://oecd.org/ctp/exchange-of-tax-information/automaticexchange.htm>.

Better targeted fiscal policies can improve outcomes for the disadvantaged. Tax policy can help redistribute incomes, and spending on public services, such as health care and education, promotes economic growth and important social outcomes in various ways. But fiscal policies also have a bearing on the distribution on income and

non-income outcomes in other ways, notably by financing social protection systems that help individuals and households cope with disability, unemployment, and inadequate or unhealthy accommodation. Transfers and public spending can increase opportunities for upward social mobility, provide social safety nets, and build a more inclusive social infrastructure.

There is a lot of scope for improving the provision of cost-effective social services in a fiscally sustainable manner in developing countries and emerging market economies. As noted in Chapter 2, inequality of incomes is, in general, considerably higher in emerging market economies than in OECD countries. Informal employment is also widespread, which limits the extent to which governments can rely on progressive taxation to redistribute income and reach the intended beneficiaries of social programmes to improve outcomes along the non-income dimensions that matter for well-being. Taxes on goods and services, customs duties and special taxes on luxury goods play a larger role in those countries than in the OECD area. The deliberate use of fiscal policy to stabilise the economy is limited by the comparatively small size of the public sector and the limited size of automatic stabilisers in the form of unemployment compensation and progressive taxation. On the other hand, as per capita incomes have risen, tax revenues have risen even faster, and there has been more emphasis on social programmes aimed at poorer households, a phenomenon which has been observed in several Latin American countries (Box 4.3).

Box 4.3. **Boosting social programmes in Latin America**

Relative to their GDP, tax revenues are considerably lower for Latin American (LAC) countries than the OECD average: 20% as against 34% in 2010 (OECD, 2014g). Tax bases tend to be narrow and biased towards non-progressive taxes in LAC, where tax evasion is also high. (Gomez Sabaíni et al., 2012) As a result, tax-benefit systems are much less redistributive in LAC than in the OECD area: while the fall in the Gini coefficient before and after taxes and transfers in countries like Poland, Portugal or Spain is nearly 20 points, the reduction in most LAC is below 2 points. Overall, both LAC and OECD countries face the challenge of selecting the tax instruments that are least distortive so as to minimise their adverse growth and employment effects. Consequently, despite significant increases in the past two decades, LAC countries still spend much less in relation to GDP on social programmes, such as education and health care, than OECD countries.

Much has nevertheless been done in several LAC countries to strengthen social protection programmes, including old-age pensions and income transfers to vulnerable households. These programmes have contributed, in different degrees, to alleviating poverty among the targeted population. In particular, unlike old-age pensions, conditional cash transfers have been particularly cost-effective, achieving considerable reductions in inequality at a relatively low cost to the government budget (IPEA, 2012). However, the growth effect of social protection programmes depends on the extent to which they are financed through higher, distortive taxes which create incentives to informality. The issue of how these schemes are financed, e.g. contributions or general tax revenue is crucial in this respect Pension reforms have been central to the social protection agenda in Latin America. Recently, non-contributory pension systems (Bono Solidario, Bolivia) and schemes providing retirement income for informal workers (Beneficios Económicos Periódicos, Colombia) have been introduced. Private pension systems have brought some of the advantages of fully-funded schemes, but limited coverage and low replacement rates persist, which intensifies the incidence of old-age poverty risk.

In developing and emerging economies public finance could play a greater role in redistribution. In many developing countries, low levels of revenue from direct income taxes and limited targeting of public spending reduce countries' capacity to use the tax-benefit system as a powerful redistribute tool, as in mature economies. In Latin America, for example, the average tax-to-GDP ratio is 14 percentage points below the OECD average of 34.6% despite an 8-point rise since 1990. Brazil and Argentina stand out as countries where tax revenues relative to GDP are already close to OECD levels (OECD, 2014g). Because of the existence of large informal sectors it is difficult to raise revenue from personal income tax, and governments tend to rely on revenue from taxes and goods and services (including customs and excise duties) more than in OECD countries. By contrast, income tax revenues in China have risen rapidly from a very low level and could reach 5% of GDP by 2015, mainly reflecting fast growth and under-indexation of the tax schedules, so that a broader array of households are now taxed (Piketty, T and N. Quian, 2009). The example of China, and of OECD countries at earlier stages of their development, underlines the importance of socio-economic policies that foster both economic growth and social advances, notably in education and health care, and favour the rise of a large middle class in the formal sector that accepts the need to share part of the burden of financing transfers to the disadvantaged.

4.2. Revisiting structural policies

Structural policies are at the heart of Inclusive Growth. Structural policies hold the promise to unlock the productive potential of individuals and enterprises in ways that can create more and better rewarded jobs, and generate resources that can be used to help poorer households. Malfunctioning labour markets make it difficult for some socio-economic groups to find and keep good jobs, and this is too often exacerbated by inadequate education and training facilities from early childhood and throughout adult life. Promoting inclusive labour markets and ensuring that workers have the skills necessary to profit from them are thus key elements of the agenda which seeks to combine strong economic growth with greater inclusiveness. Economic growth can also be boosted when firms operate in a competitive environment. But there can be losers as well as winners from structural reforms, which need to be identified when designing policies to cushion vulnerable groups from the adverse effects of reforms.

Promoting inclusive labour markets

Making labour market policies more growth-friendly and pro-inclusiveness requires addressing three main challenges: i) tackling large differences in employment rates across socio-economic groups, with particularly low rates amongst youth, women, older people and low-skilled individuals; ii) reducing persistent in-work poverty, particularly in developing countries and emerging market economies, because of the prevalence of informality, and especially among lone parents and single-earner households with children in OECD countries; and iii) addressing low job quality in terms of insecurity and strain.

To do so, policy makers need to confront a number of important trade-offs. The first is to provide effective social protection systems while at the same time promoting access to productive and rewarding work. A second is to strike a balance between providing the flexibility required by employers and the need to protect workers. A third is to provide levels of wage flexibility that are conducive to strong economic performance and low unemployment, while limiting in-work poverty and the rise in earnings inequality.

Unemployment benefits help to smooth household consumption through periods of unemployment, but can also create disincentives to work. Unemployment benefits help individuals to overcome liquidity constraints while searching for a better job, and therefore play an essential part in any well-functioning labour market (OECD, 2011a). Japan, Korea, Italy and Turkey have sought to expand and extend coverage to all workers as an incentive to higher participation (OECD, 2013o). Chile is set to improve its unemployment benefits system by increasing the average replacement rate as well as the maximum and minimum benefits. However, beyond a certain threshold, generous benefits extended over a long duration and with few conditions, can unduly reduce incentives to work. This why, in some countries, including Belgium, Finland, France, the Netherlands and Portugal, there is a need to reduce duration and replacement rates, and otherwise strengthen job-search incentives, while Spain should strengthen the link between unemployment benefits and active job-search assistance.

Striking an appropriate balance between the need to provide flexibility to employers and the need to protect employees represents a major challenge to policy makers. In countries where employment protection is much stronger for regular jobs than for temporary ones, employers have an incentive to offer temporary contracts, which tend to affect certain groups of workers more adversely. Young workers especially may get trapped into a sequence of temporary jobs and unemployment spells, and have difficulties in fully integrating into the labour market. This tends to increase wage inequality and might not have a durable impact on employment. A reduction in the level of protection of permanent jobs helps to reduce labour market duality, making it easier for vulnerable and less experienced workers to find jobs. Several countries are already working to this end, and reforms have been implemented in the Southern euro-area countries covering different aspects of employment protection legislation, such as a clarification of dismissal criteria in Spain, a decrease in severance pay in Portugal, and the adoption of measures to reduce the cases of forced reinstatement of dismissed workers in Italy. A combination of high flexibility in hiring and firing, as well as high replacement rates together with effective activation policies for the unemployed can help keep unemployment rates low, as in Denmark.

Reducing the legal extension of collective wage agreements might lower labour costs and promote employment, especially for the low-skilled, which is good for growth, but it might also contribute to widening wage distribution. As noted in Chapter 3, a reduction in the coverage of collective-bargaining arrangements has contributed to rising earnings inequality in many countries. Collective bargaining has been amended in Spain to give priority to firm-level wage agreements over sectoral ones. France introduced new legislation “*accords de maintien dans l’emploi*” (“job safeguarding agreement”) in May 2013, which enables employers to negotiate individually with the unions concerning the adjustment of working hours and wages for up to 2 years, in exchange for job security and to reduce potential lay-offs.

Flexible wages allow employers to adjust to temporary and deeper-seated changes in demand, but there are social costs. The challenge is to provide wage flexibility which is consistent not only with good economic performance and low unemployment, but also low in-work poverty and earnings inequality. The example of Germany shows that it is possible to reduce unemployment significantly in a short period of time, but with rising earnings inequality, and calls for the introduction of a minimum wage (Box 4.4). A relatively high standard minimum wage narrows the distribution of labour income, but if it is set too

high, youth and low-skilled workers may be priced out of the labour market. In developing countries, even though minimum wages may encourage informal work, they are often a useful tool against in-work poverty in the formal sector. Moreover, working-time flexibility matters. The experience of the global financial crisis has shown that working-time adjustments significantly contributed to high labour market resilience in countries such as Germany and Japan. This helps to mitigate workers' income losses, while allowing them to maintain their attachment to the labour force and skills, and the firms they work for are better able to survive downturns.

**Box 4.4. Boosting employment through labour market reforms:
The German example**

In order to address the challenges presented by stagnating economic growth, high structural unemployment and demographic ageing, Germany embarked on a series of wide-ranging labour market reforms during the period 2002-05 (“the Hartz reforms”). The reforms aimed at strengthening job-search activities for the unemployed, providing job-acceptance incentives, and encouraging labour force participation, particularly among women and older workers. In addition, measures were taken to: reduce the maximum duration of unemployment insurance benefits; close options for early retirement; lower employer social security contributions; and increase the scope for the use of temporary contracts.

The impact of the Hartz reforms on unemployment and labour force participation, along with other factors, has been impressive. After 2005, the harmonised unemployment rate has fell by six percentage points from over 11.3% to 5.5% in 2012, while the labour force participation rate increased by over three percentage points. Consequently, over that seven year period, the employment rate increased by over seven percentage points. These positive trends largely continued during the global financial crisis except for a slight reversal in the first half of 2009. The turnaround in the labour market since 2005 and its high level of resilience during the crisis reflect improved labour market matching and are sometimes dubbed the “German jobs miracle”.

However, the German miracle has not been costless: in-work poverty and earnings inequality have both increased. The increase in employment has been to a large extent driven by an increase in marginal employment or work in fixed-term or temporary contracts. The Hartz reforms promoted the use of low-wage low-hours employment contracts by, respectively, increasing the scope of Mini jobs and introducing Midi jobs. Such jobs are either exempt from employer social security contributions or subject to reduced rates. The rise in in-work poverty and earnings inequality led to an intense debate on the appropriateness of a national minimum wage. The current coalition partners have agreed to introduce one as of 2017.

Policies that facilitate access to quality jobs promote growth and reduce inequality simultaneously. Labour market reforms have a bearing on outcomes of several non-income dimensions that matter for Inclusive Growth. For instance, an increase in non-standard employment, such as involuntary part-time or temporary jobs, can lower job quality, in particular for low-skilled workers. It can also increase job strain, adversely impact mental health, and reduce worker capacity to connect to social and professional networks. As a part of a policy programme for increasing job quality, measures to improve employment prospects for youth include effective counselling, job-search assistance and temporary hiring subsidies for low-skilled youth. For instance, Estonia, Ireland and the Slovak Republic

have stepped up their job-search assistance by not only increasing resources but also by streamlining existing measures to increase effectiveness. However, such active labour market policies impose a burden on government budgets, and their effectiveness varies widely across programmes, suggesting that programme design is all-important and that countries can learn a great deal from the experience of others (Martin and Grubb, 2001).

Making work pay and fighting in-work poverty requires implementing targeted policies. Full-time work can be an effective and sustainable way out of poverty, but it does not entirely eliminate the risk of poverty, particularly in developing countries and emerging market economies, or for lone parents and single-earner households with children in OECD countries. Social transfers play a key role, precisely because they can be targeted to the most vulnerable households. In-work benefit schemes, such as the US Earned Income Tax Credit can be particularly effective (Box 4.5). In emerging market economies, conditional cash transfer programmes can provide the most vulnerable with a basic income floor, while ensuring that future generations are better equipped to participate actively in the labour market and find sustainable ways out of poverty by conditioning benefit receipt on children's enrolment in school.

Box 4.5. Balancing strict eligibility requirements with in-work support: Welfare reform in the United States

The well-studied 1996 US welfare reform provides substantial evidence on both the employment as well as poverty effects of welfare-to-work packages targeted at recipients of social assistance and similar benefits. It also highlights the trade-offs that characterise the different options faced by policy makers.

The main element of the US reform was to replace the Assistance for Families with Dependent Children (AFDC) with the Temporary Assistance for Needy Families (TANF), which is time-limited and subject to more stringent behavioural requirements. Bringing down the number of benefit recipients was a major objective associated with reforming welfare benefits in a considerable number of US states.

The evidence shows that the earnings and employment of low-income lone parents (the principal target group of the US reform) increased as a result of stepping up welfare-to-work measures, and that some of the positive employment effects can be attributed to a virtuous cycle of declining beneficiary numbers, lower spending on out-of-work benefits, and a resulting increase in funds available for work-related support (Earned Income Tax Credit (EITC) as well as the extended availability of public support for childcare and health insurance). However, because of the more rigorous eligibility requirements for TANF, and the resulting narrowing of the group entitled to benefits, average household incomes rose by less or not at all.

Source: OECD (2013a), Activation Strategies for Stronger and More Inclusive Labour Markets in G20 Countries: Key Policy Challenges and Good Practices. Prepared for the G20 Task Force on Employment.

More generally, effective social protection is important for inclusive labour markets. The global economic and financial crisis has shown that effective social protection can prevent individuals and households from becoming trapped in debilitating poverty and empowers workers to seize market opportunities, while acting as an automatic stabiliser at the macroeconomic level (ILO and OECD, 2011). It is fundamental, however, that social protection systems operate in tandem with employment policies by focusing on, for example, social benefits that are employment-related or pension reforms that raise effective

retirement ages and are accompanied by measures to promote the employment of older workers. Child-care related reforms can be particularly effective in allowing parents to remain in or re-enter the workforce. Countries like Australia and the United Kingdom have expanded the provision of early childhood education, while Korea provides subsidies to childcare for all children up to 5 years old, and Germany is significantly increasing childcare places for full-day schooling. Some policies may have short-term costs but potentially attractive future pay-offs. This is the case of active labour market policies, especially for youth, and programmes that help to reconcile work and family life.

In developing countries and emerging market economies, labour market informality delivers flexibility at the expense of inclusiveness. The share of informal employment, even excluding agriculture, is over 50% in several countries (OECD, 2011d and Jütting, 2009). While informality allows low-skilled individuals of working age to earn a living, they are usually employed in poorly paid and precarious jobs, which leads to substantial levels of inequality in earnings. Since informal workers and the firms where they work do not pay taxes, informality shifts the burden of taxes and social security contributions to workers in the formal sector. As a result, in countries with sizeable informal sectors, governments rely more heavily on indirect taxes, and typically limit access to social insurance to workers and their dependents in the formal sector, which undermines economic efficiency and impinges on the distribution of income. The loss of employment for informal sector workers can therefore be catastrophic for both the workers themselves and their families.

Strict employment protection legislation (EPL) discourages formal sector employment in some countries and is therefore a poor social protection instrument. In these circumstances EPL can end up hurting the workers it was meant to protect. High dismissal costs and restrictive severance procedures often discourage job creation in the formal sector, which penalises those vulnerable workers who could otherwise find a job in the formal sector and end up trapped in precarious jobs (OECD, 2013n). A vicious circle of exclusion, duality and low economic growth is therefore created, because firms in the informal sector – often one-man firms, or with few employees, probably family members – tend to have low levels of physical capital and productivity. Informal entrepreneurs might not be particularly skilled and resort to informal activities, because they cannot find jobs in the formal sector (Banerjee and Duflo, 2007). These firms co-exist with large, highly efficient and profitable firms in the formal sector (Bertranou, 2010), which perpetuates duality and exacerbates inequality.

Unemployment insurance schemes face particular challenges in countries with substantial informal employment. Some workers might opt for formal employment if they believe that their risk of unemployment is high, a case of adverse selection, while some workers may find work in the informal sector while receiving unemployment compensation, a case of moral hazard. In Latin America, some governments have reacted to the informal sector challenge by instituting “Unemployment Insurance Savings Accounts”, into which workers and employers contribute in periods of employment, and from which withdrawals are made when unemployed (Jütting, J. and J. de Laiglesia, 2009).

Boosting human capital for growth and equity

Education and skills are critical for growth and inclusiveness. Workers’ human capital, educational attainment and skills not only determine employment and earnings, but they also matter for health, social participation and overall living standards, which are key non-income dimensions that matter for Inclusive Growth (Chapter 2). The distribution of educational benefits early on determines in part future opportunities and successes, as

well as each person's standing later in life. People's innate abilities differ from birth, but their opportunities to develop their talents through high-quality education and training throughout their lives vary even more, leaving some people at a disadvantage to others.

A transition towards more Inclusive Growth requires ambitious educational and skills policies to reduce inequality of opportunity and outcomes. Measures that improve both growth and inclusiveness include, for example, increasing the quality and extending the provision of education, especially at the pre-primary, upper-secondary and post-secondary levels, raising tertiary educational attainment where upper-secondary attainment is already high, facilitating access to education by underprivileged groups, and expanding vocational and professional education training (VET).

Redistributing educational expenditure over the various stages of the life-cycle is necessary to leverage education's contribution to Inclusive Growth. Educational expenditure per person is typically heavily concentrated at the secondary and tertiary levels, whereas spending on both early childhood education and lifelong learning, where important Inclusive Growth-oriented outcomes can be achieved, is usually much lower on average. Many countries have started to put more resources into pre-school education, but more needs to be done. Equally, lifelong learning, training and skills policies which can remediate or compensate for unequal outcomes of formal education are needed.

An early start to lifelong learning

Effective education policies need to cover a person's whole lifespan, starting with critically important interventions in early childhood education. PISA results show that those school systems that perform the best and provide equitable learning opportunities to all students are also those that provide more inclusive access to pre-primary education. Disadvantaged students tend to have less access to pre-primary education, but some countries manage to avoid this situation. For example, Estonia, Iceland, Hong Kong-China, Japan and Korea, have smaller-than-average gaps in socio-economic background between those students who had attended pre-primary school and those who had not. These gaps are even larger in developing countries and emerging market economies, where enrolment in pre-school programmes is lower than in the OECD area. Reforms are needed in these countries to expand facilities and ensure that they are affordable, identify appropriate ways to link pre-school provision with primary schools, and co-ordinate pre-school activities with wider early-childhood interventions (UNESCO, 2012).

Social, geographic and financial factors complicate access to primary schools. In Colombia, for example, 42% of the children from the poorest households started school one or two years late, compared to only 11% of children from the richest households. Poverty also has an impact on leaving school early. In Uganda in 2006 80% of children from the richest quintile reached grade 6, compared to only 49% of children from the poorest quintile (UNESCO, 2012). Governments can prevent school failure and reduce dropout using two parallel approaches: eliminating system level practices that hinder equity and targeting low performing disadvantaged schools. For instance, reducing the direct and indirect costs of schooling by lowering or abolishing school fees; providing free stationery, uniforms and meals; and reducing the transport costs play an important role in boosting enrolment in developing countries. Gender-sensitive awareness campaigns on the benefits of education, hiring more female teachers, creating a "girl-friendly" school environment, and ensuring safe travel to and from school can help to reduce gender gaps in education in countries where girls are left behind (OECD, 2012b).

Education up to the secondary level is important for finding and keeping good jobs

Raising educational attainment up to at least lower-secondary level is likely to reduce income inequality. Individuals who reach at least the level of secondary school education are more likely to be in employment than their less educated counterparts. However, the impact of educational attainment beyond the secondary level on inequality remains ambiguous. Cross-country evidence suggests that raising the share of individuals with tertiary education in the working-age population leads to greater *earnings* inequality at first but then to lower inequality as the pool of low-skilled workers shrinks and the rates of return on investment in higher education falls (Knight and Sabot, 1983). By contrast, OECD analysis shows that raising the share of workers with upper-secondary education is associated with a decline in earnings inequality (Fournier and Koske, 2012).

Policies can help prevent failure and promote completion of secondary education. Approximately 20% of young adults leave school before finishing upper-secondary education in OECD countries, dramatically increasing their risk of unemployment, poverty and social exclusion. Five recommendations are relevant here:

- Eliminate grade repetition. Alternative strategies to reduce this practice include addressing learning gaps during the school year, introducing automatic promotion or limiting repetition to subjects or modules failed with targeted support, and raising awareness to change the cultural support to repetition.
- Avoid early tracking and defer student selection to upper secondary levels. Early student selection has a negative impact on students assigned to lower tracks and exacerbates inequities without raising average performance.
- Manage school choice to avoid socio-economic segregation. To ensure balance, options include incentives to make disadvantaged students attractive to high-quality schools, school selection mechanisms, and vouchers or tax credits.
- Make funding strategies responsive to the needs of students and schools, to ensure equity and quality across education systems, and to ensure that support goes to the most disadvantaged students and schools.
- Design equivalent upper-secondary education pathways to ensure completion. Policy options include improving the quality of vocational education and training, allowing transitions from academic to vocational studies and removing dead-ends, reinforcing guidance and counselling for students, and designing targeted measures to prevent dropout, such as creating additional pathways to obtain an upper secondary qualification or incentives to stay in school until completion.

Education policies should focus at disadvantaged students and poorly performing schools

There are major benefits for countries which boost the educational attainment and skills of vulnerable social groups, equipping them to compete for better-paying jobs. Cross-country evidence shows that if Turkey, a country with over 40% of 15 year-old students performing under the 400 points benchmark in the 2006 wave of PISA, could bring all low-achievers up to that mark, it would boost its GDP by over 1000% over the lifetime of these children (OECD, 2010d). Improving educational opportunities for the populations most at risk, such as women, migrants and rural youth, could generate progress not only in economic growth, but also in poverty, health and overall development (UNESCO, 2012).

Policies also need to improve low-performing schools and classrooms by offering a quality learning experience for the most disadvantaged. Low-performing schools often lack the capacity or support to improve. Five policy recommendations have shown to be effective:

- Strengthen and support school leadership. To attract and retain competent leaders in these schools, policies need to provide good working conditions, systemic support and incentives.
- Stimulate a supportive school climate and environment for learning. Disadvantaged schools need to focus on prioritising the development of positive teacher-student and peer relationships, as well as the use of data information systems to identify struggling students and the factors of learning disruptions. These schools may also benefit from an alternative organisation of learning time, smaller classrooms and schools.
- Attract, support and retain high-quality teachers by providing targeted teacher education and mentoring to ensure that teachers, including novice teachers, receive the skills and knowledge they need for working in schools with disadvantaged students.
- Ensure effective classroom learning strategies. Schools and teachers should use diagnostic tools, as well as formative and summative assessments to monitor children's progress and ensure they are acquiring a good understanding and a sufficient level of knowledge. Ensuring that schools follow a curriculum promoting a culture of high expectations and success is highly relevant.
- Prioritise the communication link between schools and the communities. Building links with the communities around schools, with both business and social stakeholders, can strengthen schools and their students.

Good initial education provides the necessary learning-to-learn skills to benefit from further skills development opportunities throughout adult life. Lifelong learning is most effectively supported by the development of learning-to-learn skills and transversal skills in initial schooling, and it is further developed during later stages of life. Countries with higher levels of participation in organised adult learning activities demonstrate higher literacy and numeracy skills. The large variation in education among countries at similar levels of economic development suggests major differences in learning cultures, learning opportunities at work and adult-education structures. Policies designed to provide high-quality lifelong opportunities for learning can help to ensure that the adults of the future maintain their skills. Individuals with poor skills, for example foreign-language immigrants, older adults and those from disadvantaged backgrounds, are unlikely to engage in education and training on their own initiative and tend to receive less employer-sponsored training. Second-chance options can offer them a way out of the low-skills/low-income trap. Innovative approaches to community engagement can identify low-skilled adults who require support and provide them with learning opportunities tailored to their needs.

All stakeholders, including governments, employers, employees, parents and students, need to establish effective and equitable arrangements as to who pays for what, when and how. Given the positive expected (private) returns to higher education, introducing tuition fees to make students pay at least part of the cost of tertiary education can lower disposable income inequality measured over the life cycle, especially in countries where income taxation is not very progressive (OECD, 2013f). The introduction of tuition fees in tertiary education may have a negative impact on disadvantaged groups, but these unintended effects can be offset through means-tested grants and income-contingent repayment schemes for student loans.

Developing countries and emerging market economies face specific educational challenges

Developing countries and emerging market economies need to ensure that a high proportion of the population enter education in the first place and do not leave it before they are literate and numerate. Great strides have been made in this respect. In China, for example, school enrolment up to lower-secondary level has risen from 20% to 99% in the post-war period, illiteracy among working-age adults has dropped from 80% to under 4%, and the average number of years already spent in education of those aged 15 years and over is now 9.5 years.¹ Primary school enrolment rates are now similar in most emerging market economies to those in OECD countries, although they remain lower at the secondary and tertiary levels (OECD and ILO, 2011). In some Latin American countries, disadvantaged households are encouraged to enrol and keep young children in education by means of conditional cash transfers.

Policies should facilitate the school-to-work transition, reducing young people's likelihood of being neither in employment nor in education nor training (NEET), especially girls. In developing countries the likelihood to be NEET for girls increases with age and is associated with early marriage and child bearing. Successful school-to-work transition requires integrated, multi-sectoral approaches to education, employment, migration and family programmes policies. High-quality education, better links between the educational and employment sectors, and transparency in labour market information may facilitate the transition to labour market. Discriminatory social institutions, such as laws, social norms and practices that restrict the economic and social roles of girls and women, also play a role in limiting opportunities for women. Promoting gender-sensitive vocational training programmes that are tailored to local contexts, placement and counselling services, as well as discouraging preconceived views about suitable jobs for women will facilitate girls' school-to-work transition.

Competition and product market regulations

Pro-competition reforms in product market regulations promote economic growth, which benefits all households, including the poorest. The pro-growth benefits of enhanced competition in product markets are relatively well known. Regulatory impediments to the entry of firms in product markets deprive societies of the benefits of new products and technologies that lead to productivity gains (Blanchard and Giavazzi, 2003; Nicoletti and Scarpetta, 2005). The improvements in the adoption and diffusion of new technologies that are brought about by competition are at the core of the growth effects of regulatory reforms in product markets. Indeed, the analysis carried out by the OECD and summarised in *Going for Growth*, as well as in the *Regulatory and Competition Reviews* carried out for member and partner countries, quantifies the potential benefits of policy action.

The distributive effects of pro-competition reforms in product markets are somewhat less well understood. Efforts are being made to close this analytical gap, as discussed in Chapter 3, and complement it with evidence-based analysis of the effects of pro-competition reform on different segments of the income distribution and social groups. An important channel, through which distributional effects take place, is the association of stronger competition with greater firm turnover, as poorly performing firms exit the market and more productive ones prosper, which fosters job creation and entrepreneurship. Also, by facilitating entry into product markets, pro-competition reforms result in lower prices, as well as increased availability and/or better quality, of goods and services, which benefit poor households, enhancing their purchasing power.

Vulnerable social groups may end up paying more for goods and services where there is a lack of competition. Indeed, poor and less educated consumers were found to pay more for long distance telephone calls in the United States than wealthier and better educated consumers, even after controlling for differences in usage, a finding that is associated with a lack of competition among service providers (Hausman and Sidak, 2004). Similarly, liberalisation of retail financial markets has resulted in smaller savers having access to bank accounts, where previously they relied on informal credit institutions.² An OECD study in Mexico shows that the relative negative effect of monopoly power is greatest among poor households (Urzúa, 2013).³ Countries such as Mexico and India are opening up some of their network industries to foreign direct investment so as to boost productivity and lower prices. To avoid the risk that multinational enterprises engage in anti-competitive behaviour, which undermine the efficient operation of both domestic and international markets and therefore the positive impact MNEs can make to sustainable development and enduring social progress, the OECD Guidelines for Multinational Enterprises set out government-backed recommendations on responsible business conduct, including protection of consumer interests and competition (Box 4.6).

Box 4.6. The OECD Multinational Enterprise (MNEs) Guidelines include recommendations directly relating to inclusiveness

The Guidelines are a set of recommendations on responsible business conduct addressed by governments to MNEs operating in or from adhering countries. They are supported by the representatives of business, worker organisations and non-governmental organisations through the OECD Business and Industry Advisory Committee (BIAC), the OECD Trade Union Advisory Committee (TUAC), and OECD Watch.

There are several recommendations in the MNEs guidelines which are directly related to inclusiveness, including the following:

Enterprises should:

“Encourage local capacity building through close co-operation with the local community” (chapter on General Policies);

“Encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees” (chapter on General Policies);

“Engage with relevant stakeholders in order to provide meaningful opportunities for their views to be taken into account in relation to planning and decision-making for projects or other activities that may significantly impact local communities” (chapter on General Policies);

“When multinational enterprises operate in developing countries, where comparable employers may not exist, provide the best possible wages, benefits and conditions of work, within the framework of government policies” (chapter on Employment and Industrial Relations);

“Be guided throughout their operations by the principle of equality of opportunity and treatment in employment and not discriminate against their workers with respect to employment or occupation on such grounds as race, colour, sex, religion, political opinion, national extraction or social origin, or other status, unless selectivity concerning worker characteristics furthers established governmental policies which specifically promote greater equality of employment opportunity or relates to the inherent requirements of a job” (chapter on Employment and Industrial Relations);

“Take into consideration, in applying the above principles, i) the needs of vulnerable and disadvantaged consumers and ii) the specific challenges that e-commerce may pose for consumers” (chapter on Consumer Interests).

Source: OECD (2011b), *OECD Guidelines for Multinational Enterprises*, 2011 Edition, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264115415-en>.

Competition in product markets boosts growth but does not automatically lead to greater inclusiveness (OECD, 2013d). Stronger competition between firms will lead to lower prices and higher productivity, with fewer jobs in some sectors and more in others. Relaxing anti-competitive regulations also tends to reduce the bargaining power of workers,⁴ and the loss of a job could be catastrophic for many workers in developing countries and emerging economies. But stronger competition in the production of those goods and services which the poor have a higher propensity to consume, such as basic foodstuffs, health care, housing and transport, could result in an overall improvement in income distribution at the same time as enhancing the economy's growth potential (Box 4.7).⁵ The redistributive impact of lowering barriers to entry is likely to be positive in professional services, as the reduction in prices benefit consumers at the expense of a small number of often high-earning incumbents. In sectors where low-skilled labour prevails, such as the retail sector, increased competition may widen the wage distribution, but only insofar as these workers initially benefited from rents. All in all, the impact of regulatory reforms on income dispersion (as opposed to average income levels) has to be examined on a case by case basis, distinguishing carefully between short-term effects from longer-term outcomes (OECD, 2013f).

Box 4.7. Competition and poor consumers in poorer countries

There is good evidence that lacklustre competition affects poor consumers in developing and emerging economies. For instance, Peruvian poultry farms and their trade association have conspired to block entry and eliminate competitors. Likewise, 11 Peruvian wheat flour producers and their trade association formed a cartel to end a price war. Zambian poultry firms have demanded that their biggest customer stay out of the production market – and the customer complied. Cartels and boycotting agreements have been discovered and prosecuted in the baking, milling, sugar and milk industries in developing countries. Anti-competitive practices are endemic in public transportation markets such as bus and taxi services, on which many poor consumers depend. The cement industry, on which so much public infrastructure – including public housing – relies, is riddled with cartels and abuse of dominant positions. These problems are not specific to a small group of countries but rather are widespread throughout the developing world.

There are several examples of how greater competition in developing countries and emerging market economies has helped poorer consumers. The advent of mobile telephony, and competition between operators, allows small producers to check on market prices for their output quickly and cheaply, and adjust their schedules accordingly, and mobile telephone-based money transfers for small amounts has allowed poorer people who have no access to normal commercial bank facilities to carry out monetary transactions rapidly and at minimum cost.

Source: OECD (2013d), *Competition and Poverty Reduction*, available at www.oecd.org/daf/competition/competition-and-poverty-reduction2013.pdf.

Removing subsidies which distort economic activity promotes competition and can improve resource allocation and equity. There are two general arguments against subsidies. First, the beneficiaries pay less for the good or service than the value to society of the resources used to produce them and, second, they have to be paid for by higher taxes, which can also distort competition. They are also open to abuse when well-financed lobbies put pressure on governments to introduce, retain, or increase subsidies in their sectors, benefitting producers and owners and harming consumers. The end result is that real incomes will be lower than in the absence of subsidies, and the distortion to competition can affect producers and their employees in other countries. In principle, they are acceptable only when they counteract or compensate for a distortion to competition elsewhere.

Removing some sectoral subsidies can however also have a negative social impact when they target or benefit low-income individuals. Despite their drawbacks, virtually all countries have subsidies of some kind, for example those provided to agriculture to aid self-sufficiency, while subsidised education up to a certain level is nearly universal. Subsidies are often targeted at poorer households, by focussing on staple foodstuffs, basic health facilities, and some forms of housing and public transport. Such subsidies are naturally politically popular, genuinely help poorer households and are politically very difficult to remove. If they are removed, flanking policies may be required to aid poorer households. However, in developing countries, the poorest of the poor are often subsistence farmers, who live outside the market economy and do not benefit from such subsidies.

There is a strong case for phasing out or down subsidies that are environmentally harmful. Subsidised fuels and electricity benefit mainly wealthier households that travel in powerful automobiles and heat and cool their large houses. Reforming environmentally harmful subsidies and putting in place prices to fully reflect the resource, investment and operating costs associated with natural resource use, as well as the social costs of pollution or environmental damage, are key policies to support green growth.

There are however trade-offs to phasing out environmentally harmful subsidies. Introducing or increasing environmentally related taxes or charges (e.g. energy taxes, water charges) help to cover the full costs and promote more efficient use of the resource, but can have a regressive impact. To address this, governments often introduce exemptions or subsidised rates for certain uses (e.g. fuels for domestic heating or fishing boats, electricity for irrigation pumping). Universal applications of such exemptions or subsidies often lead to inefficient outcomes that benefit the better off (Box 4.8), and should thus be removed to maintain the price signals of the taxes and charges. Negative social impacts from the

Box 4.8. Mexico's moves on energy reforms to address environmental and social concerns

Mexico is making efforts to reform its subsidies to fuel and electricity, while more effectively supporting the poor. In 2008, energy subsidies (1.8% of GDP) in Mexico cost more than twice the amount spent on anti-poverty programmes. Although these subsidies were reduced to 1% of GDP in 2011, they are still highly regressive, with the poorest 20% of the population capturing less than 8% of transport fuel subsidies and only 11% of residential electricity subsidies. Using some of the revenues from reducing energy subsidies to better target support directly to low-income households would benefit the poor, and at a much lower cost to the government budget. Similarly, 90% of agricultural price support in Mexico and 80% of electricity subsidies for irrigation-water pumping benefit the richest 10% of farmers. Overall, Mexico spends more on subsidies to electricity for pumping irrigation water than it does to improve irrigation infrastructure.

The 2013 budget aims to reduce fuel subsidies, and since 2011 irrigation water pumping subsidies in some aquifers have been replaced with direct cash transfers. The carbon tax law has just been passed in the Senate in November 2013, although the carbon tax rate is lower than initially planned and natural gas is taxed at zero rate. Nonetheless, this achievement sends a strong international signal about Mexico's commitment to green growth and opens the doors for gradually increasing the carbon tax rate in the future. Efforts have been also made to phase-out energy subsidies. Using some of the revenues from phasing-out energy subsidies to better target support directly to low-income households would benefit the poor and at a much lower cost to the government budget. Conducting a voluntary peer review of its fossil fuel subsidies in the G20 process would further aid Mexico with energy reforms, while addressing social concerns through an exchange of international experiences.

Source: OECD (2013p), *OECD Environmental Performance Reviews: Mexico 2013*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264180109-en>.

reduction or suppression of energy subsidies are better addressed by better targeting compensation measures only for low-income households, or through separate social security systems. Further, a full assessment of the income distributional effects should also include the indirect effects – such as price increases on taxed products, employment effects of using environmental tax revenues, as well as associated environmental benefits.

4.3. Enabling an equity-friendly business environment: Innovation and entrepreneurship

Innovation policies and Inclusive Growth

Innovation is a driver of long-term economic growth and has an effect on the distribution of opportunities and outcomes. Innovation consists by and large of introducing new products and services in the market, or better ways of producing, marketing and distributing them. Innovation is the key driver of productivity enhancement and therefore economic growth over the longer term. However, innovation can also accentuate income disparities if technological change opens up opportunities for individuals holding certain comparatively rare skills to the detriment of those who do not possess them. Moreover, policy settings that impinge on the adoption and diffusion of innovations, such as the regulatory environment in product and capital markets, education and skills, also have a bearing on how individuals benefit from new technologies.

Innovation and innovation policies tend to impact the performance of firms asymmetrically. Particularly in emerging and developing countries, a small group of high performance innovators – “islands of excellence” tend to co-exist with groups of poorly performing firms and an often sizeable informal economy. While the development of high-tech activities is important for economic growth, it is critical to understand to what extent policies also provide sufficient support to a wider group of innovators: they must ensure that the knowledge provided by “islands of excellence” trickle down to the rest of the economy. Framework conditions, such as possibilities for accessing finance or tapping into knowledge networks, are particularly important for the diffusion of new technologies and for “technological followers” to benefit from cutting-edge innovation (Bas and Paunov, 2014). In developing countries and emerging market economies, adaptation of pre-existing technologies to local conditions and use of new-to-the-firm products are important aspects of technological diffusion, which can be enhanced through competition between firms.

Innovation also has a geographical dimension, by affecting the distribution of economic activity and jobs between urban and rural areas or among different neighbourhoods in cities. Typically, innovation activity is concentrated in a few regions, generally advanced metropolitan areas, often close to major universities and research centres, which creates a link between innovation and urban/regional development policy (OECD, 2011c). Because these linkages depend on country-specific conditions and complex policy interactions, more analysis is needed on the geographical dimension of technological diffusion and the effects of innovation on local residents (“territorial inclusiveness”).

Low-income countries face specific challenges for making innovation the engine of economic development. In some countries, “inclusive innovation” initiatives aim at providing poor and lower-income groups with access to innovative products in the areas of food, health and basic livelihood. Many inclusive innovation projects consist of developing business models that could cover at least in part the costs of diffusion of innovations to low-income individuals and small businesses. At the same time, “grassroots innovations”,

which are developed by the poor, have great potential for creating opportunities for individuals and households to move out of poverty. Grassroots innovations in agriculture are particularly important. A major policy challenge in this area is to create the conditions for these initiatives, which are locally based, to upscale and reach more people: it is often an issue of capacity building and removing market barriers. Success stories such as Kenya's mobile banking service M-PESA, which now reaches an estimated 15 million users, indicate that opportunities for up-scaling exist.

Innovation policies do not necessarily reach their intended beneficiaries. In general, innovation policies are usually designed with no consideration as to their impacts on Inclusive Growth. Tax incentives are conventional instruments to foster innovation, but

Box 4.9. The digital revolution: Is it good for all?

The Digital Revolution, including the emergence of the Internet and the fundamental transformations brought about by social media, have encouraged innovation and affected the overall productivity of modern economies. These transformations have, in particular, facilitated better access to knowledge and improved means of communication for a wider group in society, including disadvantaged groups in developing and emerging countries.

The benefits of innovation are traditionally perceived to flow disproportionately to investors in, and managers of, larger technologically sophisticated enterprises (OECD and WB, 2012). No particular skill is needed to operate a basic cell phone, but using ICT as a tool to run a business more efficiently or do research requires an investment of time and money, access to the Internet, a reliable electricity supply, and some literacy and numeracy skills. In consequence, Internet penetration as a percentage of the population in North America, Europe, Latin America, Asia and Africa is around 80%, 60%, 40%, 25% and 14% respectively. Innovation can also accentuate income disparities within countries to the extent that it opens up opportunities for high-skilled individuals and closes them down for the lower and middling-skilled. ICT policies can support Inclusive Growth by helping the development of adequate ICT-based applications that support innovation activities of entrepreneurs and small businesses. A variety of ICT-based applications have brought fundamental changes to disadvantaged groups including also disadvantaged rural communities in developing and emerging countries. They include for instance:

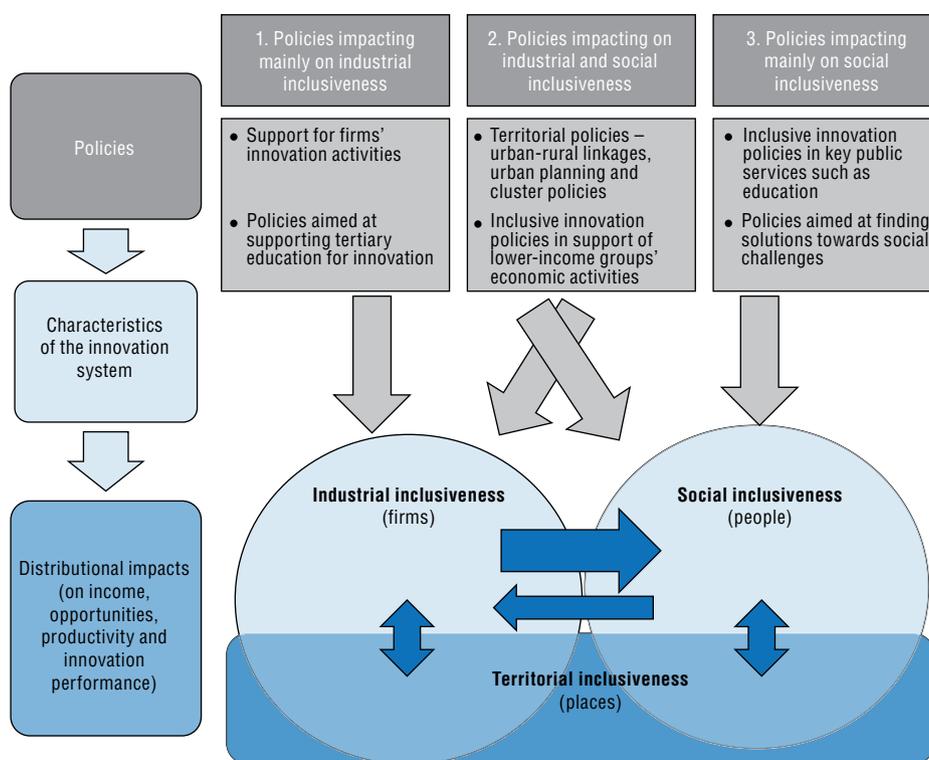
- KACE, Kenya: Provides daily market information on 20 commodity prices, facilitates offers and bids to match farm outputs with demand from wholesalers, and facilitates links between farmers and buyers (e.g. for contract negotiations and commodity transport).
- Farmers Texting Centre, Philippines: Offers an innovative SMS-based service for answering agricultural queries mainly about rice production from farmers, extension workers and other actors. Also provides technological updates on rice production and a virtual network to facilitate interactions among farmers and clients.
- Fisher Friend, India: Provides timely information on local fish markets, weather, the sea, and timely and critical information for fishers. It “also increases their knowledge base by providing information on government schemes and entitlements, health services, directory services, and a marine toll-free helpline”. Collaboration between the M.S. Swaminathan Research Foundation (MSSRF), Tata Teleservices in India, Astute Systems Technology, Wireless Reach, and Qualcomm.

At the same time, not only are lower-income groups at a disadvantage with respect to access, they are also likely at a disadvantage for reaping the benefits of ICTs, notably because skills help exploit the opportunities ICTs offer and they are complementary with innovation and technical change. A wider skills base will, therefore, be key to expanding the group of successful innovators.

Source: OECD (2013), *Innovation and Inclusive Growth*, OECD Publishing, Paris, and Zhenwei Qiang et al. (2011), “Mobile Applications for Agriculture and Rural Development”, ICT Sector Unit, World Bank, Washington, DC.

they tend to benefit firms that invest heavily in R&D, and exclude smaller firms and those operating in the informal sector (Figure 4.2). Government grants and subsidies also tend to benefit larger firms and particular sectors or activities, often high-tech ones, at the expense of more basic, lower-tech innovations that might benefit a larger share of the population. It is therefore important to broaden the reach of innovation policies to smaller businesses and entrepreneurs, which often engage in a broader range of knowledge-based activities that go beyond traditional R&D. These innovators also often play a crucial role in the diffusion of new technologies and in adapting them to local needs and conditions. Toner (2011) notes that much of the innovation in OECD countries happens incrementally, where shop floor workers have the discretion and potential to innovate as they ‘learn by doing’, and companies have the absorption capacity to take these innovations on and mainstream them. In such cases, managers may be more likely to reward a broader section of the workforce as profits rise and product market strategies evolve. Innovation that goes beyond R&D includes changes in institutions.

Figure 4.2. **Impacts of innovation policies on inclusiveness**



There are potential trade-offs between the positive impact of innovation on growth, and the distribution of its benefits. Traditionally, innovation policies focus on the growth impact, but consideration should also be given to supporting innovative activities and products that improve the welfare of low-income groups. Success stories such as Kenya's mobile telephone banking service M-PESA, which now reaches an estimated 15 million users, indicate that opportunities exist. Innovation policies in practice can be exclusive. R&D tax credits, for instance, which focus on firms investing in R&D and, thus, do not support those focusing on other types of innovations. They tend to support larger businesses with R&D departments over smaller ones. A lack of suitable framework conditions also affects small businesses more substantially than larger businesses, and will also hamper “industrial inclusiveness”.

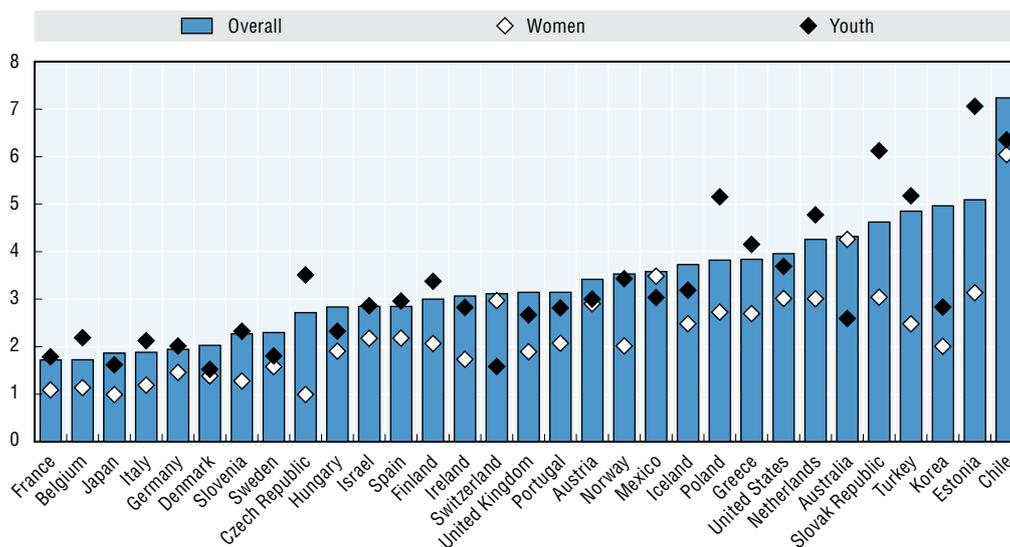
Framework conditions matter for innovation and inclusiveness. With regards to information technologies, addressing “digital divides” is a critical condition for widespread impact. Adequate framework conditions that ensure the Internet is free and open are also essential. Expanding cloud computing services to provide on-demand computing services can also be an effective means to strengthen access for small-scale businesses to a critical input for their innovation performance. Similarly, providing conditions for engaging in innovation processing are critical, including access to finance, skills and other critical “enablers” of innovation.

Entrepreneurship for all

Entrepreneurship is a key conduit for inclusiveness. This is especially the case if disadvantaged social groups have the same opportunities as others to start and operate successful businesses. However, most entrepreneurs are from higher social groups: a study by the Global Entrepreneurship Monitor found that in the United States, a majority of entrepreneurs were male, wealthy, well-educated, white and born in the country (Pressl, 2013). Also, there were only 9 million self-employed women compared with 21 million self-employed men in the European Union in 2013.⁶ In OECD countries, most new businesses are owned by men (Figure 4.3). At the same time, there is an entrepreneurship quality gap affecting disadvantaged social groups; indicators of business turnover, income from self-employment and business survival rates are all significantly lower for women, youth and immigrants (European Commission, 2005).

Figure 4.3. **Women in OECD countries have relatively low business start-up rates**

Percent of the population owning a new business between 2008 and 2012



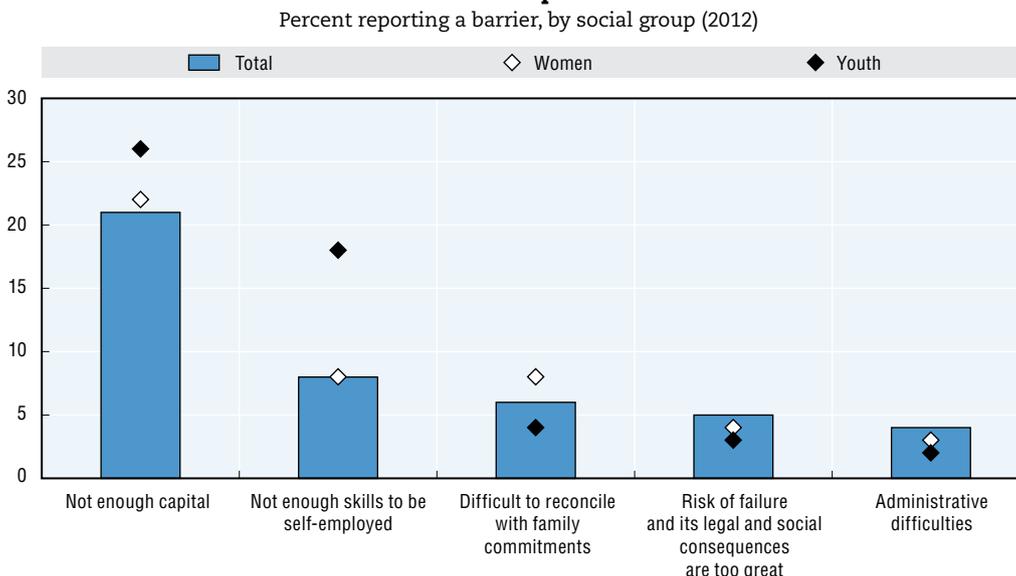
Note: The new business ownership rate refers to the proportion of the population that is currently an owner-manager of a new business that has paid salaries, wages or any other payments to the owners for more than three months, but not more than 42 months.

Source: OECD based on data of the 2008-2012 adult population surveys from the Global Entrepreneurship Monitor.

Disadvantaged social groups, such as women, youth and immigrants, face barriers to entrepreneurship. Social norms, networks and welfare systems, as well as access to finance and skills for entrepreneurship, are important obstacles that call for corrective policy action (Figure 4.4). For example, for women, policy action could involve efforts to

make childcare services available to entrepreneurs with young children, build female entrepreneur role models and networks, and adjust social security regimes to offer finance for maternity leave to the self-employed (Pfau-Effinger, 2004 and Achtenhagen and Welter, 2011). For youth, start-up programmes combining finance, coaching and mentoring have proved to be effective.

Figure 4.4. **In the EU, youth and women often face stronger barriers to starting an enterprise**



Source: European Commission (2012), "Entrepreneurship in the EU and beyond", Flash Eurobarometer 354.

Access to finance and other essential business services are necessary to facilitate inclusive entrepreneurship. Facilitating access to credit for the underserved population, such as small enterprises and the self-employed can do a lot for inclusiveness but also for growth, by removing obstacles to the expansion of businesses and the formalisation of labour relations. Many immigrant groups have to rely on their own sources of finance and typically experience high rates of refusal for bank loans. They also often lack the necessary skills and networks for developing high value-added businesses (Basu, 2006 and APCE, 2002). Even the allocation of credit by non-price mechanisms, such as directed credit, grants and subsidies, often ends up favouring politically connected groups, rather than the underserved population, therefore creating distortions and inefficiencies that are harmful to growth. At the same time, it is important to provide complementary business services focused on advice, coaching and skills development to entrepreneurs and potential entrepreneurs in order to maximise their chances of running successful businesses and contributing to growth.

Entrepreneurship policies should focus on two broad objectives. These include channelling targeted support at the specific problems faced by entrepreneurs from outside the mainstream, especially in the areas of skills and finance, and ensuring that support options are accessible to all segments of the population and not just to the "typical" business or entrepreneur. In particular, key policy recommendations include:

- **Incorporating entrepreneurship support measures for marginalised social groups in active labour market policies.** Schemes such as the Ich-AG ("Me-inc") in Germany have offered monthly allowances to unemployed people who start businesses to help them

cover their living expenses. Evidence shows that 5 years after business start-up 50-60% of former Ich-AG participants were still in full-time or part-time self-employment.

- **Removing disincentives to business start-up in welfare systems, for example by providing child care facilities for those with young children, and helping to finance the transition from unemployment to self-employment.** Spain's Self-Employed Workers' Statute (*Estatuto del Trabajador Autónomo*) came into force in 2007 and aims to give more legal protection to self-employed people and promote equal working conditions for self-employed men and women. The law also introduces provisions for maternity and paternity leave for the self-employed, as well as childcare.
- **Promoting entrepreneurship skills with entrepreneurship education initiatives, targeted advice and coaching initiatives.** For example, the "Going for Growth" project in Ireland provides group support, networking and workshops for women entrepreneurs to boost their entrepreneurship skills and increase their ambitions. A key to the success of this project is the central role that experienced entrepreneurs have in encouraging and teaching participants.
- **Developing microcredit programmes, including through new mechanisms such as crowd funding.** One example is "Seedmatch" in Germany, which is one of the few equity-based platforms in Europe, enabling funders to invest in new start-ups and receive shares in return. Seedmatch carries out an in-depth assessment of the business proposals, which increases the transparency of projects.
- **Facilitating access to credit for small enterprises and the self-employed.** One of the best-known microcredit examples is ADIE in France, which supports businesses started by the unemployed who cannot access traditional financial institutions. It offers loans of up to EUR 6 000 at market interest rates, start-up grants funded by the government or by local authorities and non-interest bearing subordinated loans. These financial products are complemented with business support services.
- **Making mainstream entrepreneurship support accessible and relevant to diverse client groups, using targeted marketing.** An example is Finland's state-owned risk financing company, Finnvera Plc, which offers targeted loans for women entrepreneurs. These loans are derived from mainstream products but are targeted and marketed exclusively to women.
- **Using strong selection criteria to target support at those with the best projects, who are the most likely to succeed.** One example is the Prince's Trust Youth Business Scotland, which supports "un-bankable" young entrepreneurs. The scheme couples targeted business development services and microfinance that is awarded through competitive mechanisms.
- **Accepting that many start-ups will fail, that this is not a policy failure, but that it will require the appropriate modification of policies.** For example, the Start-up Credit for Partially Occupationally Disabled Persons in the Netherlands provides start-up loans for business creation to partially disabled people who can nevertheless participate in some capacity in the labour market. Given the greater difficulties this group faces in the labour market, and the social as well as economic objectives of the policy, the targeted survival and growth rates from these businesses should not necessarily be set as high as for mainstream entrepreneurship programmes and complementary support may be considered. The scheme was recently adjusted to include more coaching following

evaluations of similar schemes in other countries that have highlighted the significant role that can coaching have in successful business start-up.

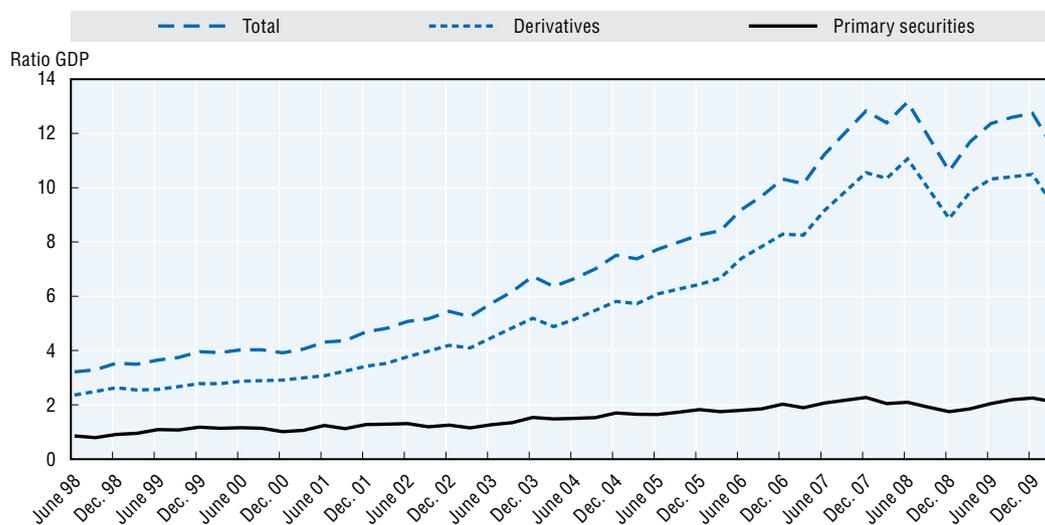
4.4. The financial sector and its relation to Inclusive Growth

Unequal rewards from the operations of the financial markets

Access to finance is central to growth and job creation, but an increasingly complex financial sector puts small savers and investors at a disadvantage. Financial intermediation plays a central role in supporting growth by channelling savings to productive investment, facilitating risk pooling and reducing the cost of capital and investment. However, in their role as financial intermediaries, the financial sectors of OECD countries in particular have moved into trading ever more complex instruments, such as derivatives, on their own account in order to diversify and shift risk (Figure 4.5). Trade in derivatives and other complex financial instruments can be highly profitable, but it requires highly-skilled and highly paid professionals. Computer-based trading strategies have increased short-termism, channelling the rewards mainly to financial market participants (Box 4.10). This increased sophistication of financial markets and products makes individual financial decisions, for instance saving for retirement, more challenging, and more and more financial risks are being transferred onto individuals who are not necessarily well equipped to bear them. It is especially problematic, since pension and health care reforms are making pay-as-you-go public pensions and health support less generous, and defined-benefit private pensions less available.

Figure 4.5. **The growth of derivatives has outpaced traditional financial assets**

Global notional derivatives versus primary securities



Source: OECD calculations based on data from Bank for International Settlements (BIS); Thomson-Reuters, Datastream; World Federation of Stock Exchanges.

The industry of managing household savings has boomed but the benefits of greater financial intermediation have increasingly benefitted the well-off. In many countries, pension systems are increasingly relying on a funded component where the ultimate pension benefits depend on the performance of stock markets. In the last decade pension funds, insurance companies and investment funds have doubled their assets under

management from USD 36 trillion to almost USD 75 trillion.⁷ A large portion of these assets is invested in publicly listed stocks. It is estimated that Europeans between the ages of 30-65 today allocate 35% of their savings to the stock market, mostly through funds and other intermediaries (McKinsey Global Institute, 2011). Despite an increased reliance on financial assets among broad segments of the population, an important driver of increased income inequality, as discussed in Chapter 2, is a skewed distribution of capital income. The benefits of greater financial intermediation appear to have gone disproportionately to higher-income households.

Box 4.10. Short-termism crowds out long-term investment in stock markets to the benefit of traders

The equity market structure has significantly changed over the last decade. Trade practices have become more sophisticated, markets more fragmented and new instruments have been increasingly dominating the markets. Trading in equity increased much faster than the supply of new equity capital through initial and secondary public offerings in the stock exchanges. Particularly in the pre-crisis period, between 2004 and 2007, the increase in trade volume was three times the increase in new equity capital raised.

An important change in trading practices and investment strategies over the last decade is the dominance of algorithmic trading, which means that orders are executed by computer-based systems according to a pre-designed set of rules and procedures. The current public discussion focuses primarily on one particular type of algorithmic trading, namely high-frequency trading (HFT), which represents the largest, and in many cases an increasing, share in trade volumes in some OECD markets. HFT is characterised by very short timeframes for transactions (e.g. milliseconds) and cancellation of orders shortly after the submission. Today, HFT accounts for more than 60% of the total trading volume in the US equity market. In Europe, it represents some 38% of total trade volume in 2010 with an upward trend.

It is important to note that HFT is more than a technological advancement allowing high-speed computer trading. From a corporate governance perspective, it can also be seen as an investment strategy with a very short-term focus. The goal is not to assess and trade on genuine information concerning the long-term performance of any individual company, but rather to benefit from short-term arbitrage opportunities that are often obtained by unique and fast access to trading information. Defenders of HFT claim that it makes markets more liquid and thus reduces the cost of transactions. Arguably, those cost savings accrue mainly to the HFT traders themselves.

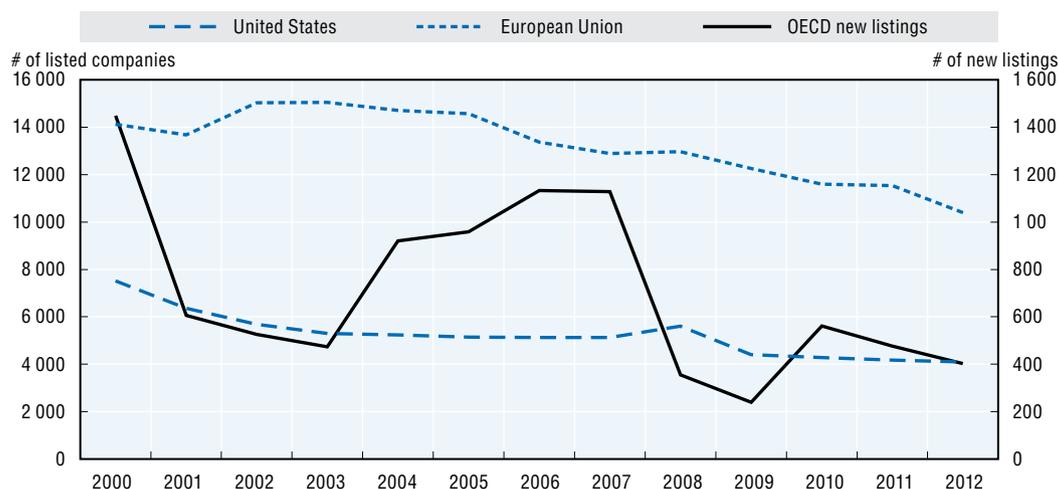
Source: Isaksson and S. Çelik (2013), "Who Cares? Corporate Governance in Today's Equity Markets", OECD Corporate Governance Working Papers, No. 8, OECD Publishing, Paris, <http://dx.doi.org/10.1787/5k47zw5kdnmp-en>.

Companies now finance themselves differently, and their profits are less equally shared. In the last decade, many companies abandoned the public stock markets as a way of raising finance, relying instead on internal funds or raising money on the bond markets via investment banks. There has also been an almost 60% drop in listed new companies in OECD economies (Figure 4.6). Indeed, in the United States the stock market now has only half the number of publicly traded companies that it had ten years ago. At the same time, the number of listed companies in Europe decreased by some 27%. The decision not to be publicly traded is obviously the choice of the individual company or entrepreneur. However, if rules, regulations or tax treatment provide a bias in terms of choice it is a public policy concern, since there are good reasons to believe that the way companies are

financed and managed will affect the distribution in society of the wealth that companies create. When companies become increasingly privately held, the general public is excluded from sharing in their profits and wealth creation.

Figure 4.6. Companies, old and new, are abandoning the stock markets

Number of companies listed on stock exchanges and new listings over 2000-2012



Source: Thomson Reuters New Issues Database; World Bank World Development Indicators.

The build-up of debt in the run-up to the global crisis did not benefit poor households. Against a macroeconomic background of low interest rates and rising prosperity, OECD households took on more and more fixed-interest debt, especially mortgage debt. But the value of their assets – real estate and financial assets – was vulnerable to a downturn. The new international rules that regulate banks enabled them to borrow cheaply and invest more riskily. Ever more sophisticated instruments facilitated the creation of debt and were also used to encourage poorer households to take on more debt. This was most prominently the case with subprime mortgages that enabled them to become homeowners, but many were finally unable to service the mortgages. A combination of financial innovation in general, changes in the business models of banks, and the inability of many households to make financial decisions in an environment of increasingly complex financial services and products led to a build-up of debt and growing vulnerability for lower-income, less educated individuals and households.

Rethinking the financial sector

A resumption of credit growth in many OECD countries depends on comprehensive reform of policies and regulations. Comprehensive reform packages include initiatives to strengthen the capital base of banks and make their business models safe by reducing leverage and making risk-weighting of assets less complex and less open to regulatory arbitrage (Blundell-Wignall, Atkinson and Roulet, 2014a). There should also be resolution mechanisms in place for an orderly wind-down of weak banks (Schich and Kim, 2013). But to help prevent bank failures, business model reforms that separate high-risk activities of universal banks (particularly with respect to proprietary activities) should be a priority. Achieving consistency in such business model reforms, already in place or in preparation (US Volcker rule, UK Vickers and EU Liikanen proposals), will be important. Fragmentation of approaches should be avoided, because securities firms operate across national borders and will take advantage of regulatory loopholes. The competitive structure of the banking

sector should also be of policy makers' concern. Empirical evidence indicates the positive role, based on relationship banking, played by smaller banks during the crisis, as they are better able to support households and firms when they go through rough times.

The structure of bank managers' remuneration could be reformed to discourage them from adopting risk strategies that are not socially optimal. Bonuses could be paid in part in assets whose value is tied to that of the parent bank, and some part of large bonuses earned in good years could be made repayable in the case of bank failure. In addition, managers and directors could be obliged to sign affidavits stating that they had checked the risk management systems under their responsibility, and found them satisfactory, thus opening them to lawsuits if risk-taking is found to be excessive (Goodhart, 2013).

It is also desirable to reduce the traditional high reliance of SMEs on bank finance and broaden the range of non-bank financing instruments available to SMEs and entrepreneurs. This would enable them to continue to play their role in Inclusive Growth, innovation and employment. Revitalising securitisation by making it safer, simpler and more transparent is an important element in this effort, and perhaps needs some (initial) government and regulatory support. For mid-sized companies, bonds and private placements may also provide useful alternatives. For high-growth firms, equity finance, including venture capital, is important, and policy can also play a role in supporting seed finance and early stage finance. Many dynamic SMEs might also benefit from equity-type products, in particular "mezzanine finance", a variable mix of equity-type and debt-type financing, normally senior only to common stock. Crowd-funding is another avenue that opens financing possibilities for SMEs. Furthermore, the role of equity markets is important as they allow venture capital companies to be sold to the public in an initial public offering (IPO), and more generally can provide risk capital for mid-cap companies (conventionally companies with a market capitalization of between USD 2-10 billion.⁸

Corporate governance reform is fundamental to the well-functioning of a dynamic private sector and Inclusive Growth. The ability of equity markets to serve the real economy has weakened. This concerns both the primary markets, where growth companies should be able to raise risk capital to innovate, expand and create jobs, as well as the secondary markets where the shares of already listed companies are traded. A decade of far-reaching changes in investment practices, corporate ownership structures and the functioning of stock markets is challenging the conventional wisdom and the relevance of current corporate governance standards. Corporate governance policies should be adapted to better serve the needs of growth companies and those intermediaries who want to take a long-term perspective. Reducing the conflicts of interest and the complexity in the investment chain from households to corporations will provide an opportunity for achieving Inclusive Growth where individual households can share in the wealth created by the corporate sector.

Institutional investors such as pension funds, insurers and sovereign wealth funds, represent a potentially major source of long-term financing for illiquid assets such as infrastructure. Over the last decade, these investors have been looking for new sources of long-term, inflation protected returns. Asset allocation trends observed in recent years show a gradual globalisation of portfolios with an increased interest in emerging markets and diversification into new asset classes. However, the role of institutional investors in long-term financing is constrained not only by the short-termism increasingly pervasive in capital markets but also by structural and policy barriers such as regulatory disincentives, lack of appropriate financing vehicles, limited investment and risk management expertise, transparency, viability issues and a lack of appropriate data and investment benchmarks for

illiquid assets. The matching of long-term liabilities for pension and insurance companies requires sound long-term investments that are suitable for pension funds in terms of viability and duration. Infrastructure investment has the potential to develop financing vehicles that could be well suited to such aims. Developing the right policy frameworks and financial products is therefore a critical and integral part of financial reforms and policy making.

Focusing on individuals and financial consumers

Policies also need to address these problems at the level of individuals and consumers of financial services. Fostering financial education and consumer protection is essential to equipping the most vulnerable groups with the basic skills and competencies they need in order to efficiently use financial services available to them and make informed financial choices as well as to effectively protect these groups against the effects of unfair practices. With a view to consistently addressing these issues, two sets of Principles endorsed by G20 Leaders in 2011 and 2012 respectively were developed on *Financial Consumer Protection* by the OECD dedicated task force and on *National Strategies for Financial Education* by the OECD and its International Network on Financial Education (INFE). These Principles provide a fundamental framework and guidance to design and implement policies to develop consumers' financial awareness and skills while at the same time ensuring that they are adequately informed and protected in their dealings with financial institutions.

Tailored strategies and initiatives based on evidence can be designed to strengthen the population's financial literacy, taking into account individual needs and abilities, as well as the maturity of financial markets. In particular, policies need to target vulnerable groups of the population, such as women, as detailed in the OECD/INFE Policy Guidance (on addressing women and girls' needs for financial education and awareness) and should start early in individuals' lives and preferably in schools to reach out to the population at large (OECD, 2014b and OECD, 2013q).

Developing countries and emerging market economies face their own specific challenges to tackle financial exclusion. Typically, bank branches are in towns, but many of the poor live in rural areas. Poorer workers often work in the informal sector and do not qualify for credit. They also often live in informal settlements and do not have land titles that would allow them to use this capital as collateral against which to apply for a bank loan. The challenge is to make banks more competitive and credit allocation more equitable. In many countries, regulations discourage competition among banks and between banks and other financial intermediaries that could cater to poor individuals and vulnerable social groups, such as credit co-operatives. Subsidised or directed credit, often granted through state-owned banks, also often go to larger or politically well-connected enterprises and benefit wealthier individuals (Levine, 2012). More competition, and reform of public banks, would make banking more attractive for poorer households and lead to a better allocation of household savings.

4.5. Improving access: The role of infrastructure and public services

Equitable access to efficient socio-economic infrastructure and effective public services is essential to achieving Inclusive Growth. Improving access to vital services – including transport, energy, information and communication technology, drinking water, sanitation, irrigation, healthcare and education – contributes to economic growth, and boosts inclusiveness. In mature economies this can take the form of increasing competition in service provision to ensure that consumers pay lower prices, or focusing infrastructure

planning on people's needs. In developing countries and emerging market economies improvements in infrastructure are an integral part of economic development. Access to paved roads, electricity and telecommunication networks allow people to draw higher dividends from their skills, efforts and experiences. At all stages of economic development, enhancing access to infrastructure and public services provides citizens with a means to take advantage of economic opportunity and helps them to live longer, more prosperous and fulfilling lives.

Regulating infrastructure matters for Inclusive Growth

Infrastructure is a public good, but well-designed regulation is needed to avoid excluding potential users. The ability of regulatory reform to boost growth is well known, as is the potential of bad regulation to dampen economic activity. Over the last two decades, experience in OECD countries has highlighted the many costs associated with over regulation. At the general level, constraints in administrative and regulatory capacity reduce the likelihood that regulation will achieve its intended results, and increase the likelihood of unintended costs, which may disproportionately affect certain vulnerable groups. On the other hand, effective regulation can extend access to vital infrastructure to previously underserved segments of the population, bolstering equality of access and contributing to future economic growth. There are three forms of regulatory intervention open to government:

- **Controlling Market Entry:** Relaxing the conditions for market entry can lead to more competitive and effective delivery of infrastructure services. OECD countries have used both horizontal unbundling - i.e. separating an existing electricity enterprise into several generation companies - and vertical unbundling - i.e. separating electricity generation, transmission and distribution activities - to provide new opportunities for competition and market entry.
- **Controlling Prices:** Price regulation is motivated by concerns over abuse by monopolies and the desire to use infrastructure prices to meet various social objectives. However, over the longer term, government attempts to control prices can have negative effects on equity. Regulators need information on utility costs, consumer characteristics and price responsiveness to set appropriate prices, and they need additional institutional capacity to enforce price regulations. Infrastructure prices tend to be politically sensitive, and price regulation has been vulnerable to short-term political considerations leading many OECD countries to rely more on price setting through competition.
- **Controlling Quality:** Regulating service quality based on environmental, safety, health and other considerations can enhance the inclusiveness of infrastructure by ensuring that all population segments have access to higher quality services. In contrast, quality controls can also have the opposite effect, reducing inclusiveness, where the increased costs associated with regulation are passed on to service users. Indeed, in many OECD countries, enhanced competition has required a more dynamic, output-focused approach to the role of quality regulation, for example where regulation of quality is justified, setting standards at the appropriate level has proven to be essential.

Improving access to urban transport

Better transport facilities spur growth and can improve inclusiveness. More efficient⁹ transport services facilitate trade and widen the geographical space for competition by reducing the cost of distance, thereby boosting economic growth. This is particularly true

in cities and urban areas. Well-developed, reliable, and accessible urban transport systems mean that workers can seek work further from their homes, making for a better matching of skills and jobs.

There are efficiency and equity trade-offs when implementing new urban transport systems. New above-ground mass-transit systems and urban motorways save time for those who use them. The value of the time saved and the impact on congestion elsewhere in the transport network are the most important factors taken into account when planning and implementing new systems or extensions.¹⁰ Adding to transport infrastructure often means cutting through existing residential areas. This makes it more difficult and costly for residents on one side of the new transport facilities to cross to the other side, and lowers environmental quality for those living close to them. In addition, the time saved by users of the new infrastructure is offset to some extent by the time lost by those inhabitants whose ability to easily access work, school, other activities and amenities has been reduced.

Defining an affordable and accessible network is technically difficult, but essential to Inclusive Growth. Inadequate transport, with long waits and multiple transfers, pushes those with sufficient means into their cars and results in a radical reduction of mobility for the less fortunate. Major conurbations can contain zones within them which are ill-served by public transport, leading to a vicious circle of low property prices, concentrated poverty, lacklustre facilities and people who cannot afford to travel to work by private transport (OECD, 2012h).

Making urban transport more inclusive requires a holistic planning approach. Improving access to urban amenities calls for a drastic rethink of the urban planning paradigm, moving away from concerns about average speeds, travel times and the percentage of driving time spent in congestion. Instead, a new paradigm should focus on citizens' ability to access urban facilities, services and opportunities, such as jobs, public services of various kinds, shopping and leisure. A change in planning paradigm also implies changes in governance and in funding:

- Decisions at the strategic level of urban mobility covering all transport modes should be concentrated in the same political body at the metropolitan level. All modes compete for limited financial resources as well as public space, and the conditions offered to each may have a significant impact on the shares of mobility they represent, as well as their respective contribution to ensuring better access.
- Zoning and planning instructions should always include an explicit study of the ensuing access levels for the future residents or workers, as well as for those in nearby areas, and how that relates to the strategic objectives of access levels.
- Funding of urban mobility must be addressed jointly for all modes of transport, and mobilise resources from direct beneficiaries (the users of the system) and from indirect beneficiaries (those who obtain benefits from the wider access provided by the mobility system). Direct subsidisation of the mobility of citizens with lower economic means or with reduced mobility, including older and disabled people, may be required, but widening the subsidy to all citizens (by lower public transport prices in general) can contribute to a cost escalation that ultimately results in a lower reach of the network and quality of services.

Enhancing equitable access to energy infrastructure

As in the case of transport, adequate and affordable energy infrastructure plays a vital role in ensuring that the benefits of economic growth are more equitably distributed among the population. This is particularly true in developing countries, where “energy poverty”, or the lack of access to electricity and clean cooking facilities, is common. Access to modern forms of energy is essential for the provision of clean water, sanitation and health care, and it provides developmental benefits through the provision of reliable and efficient lighting, heating, cooking, mechanical power, transportation and telecommunication services. Almost all the population lacking access to energy infrastructure lives in rural areas of Sub-Saharan Africa and developing Asia. In addition, the World Health Organization estimates that more than 1.45 million people die prematurely each year from household air pollution due to inefficient biomass combustion, a direct result of energy poverty (WHO, 2008) A significant portion of these are young children and women.

Despite real progress made by some emerging market economies in recent decades in providing near-universal access to electricity supplies and clean cooking facilities, the challenge ahead lies in the large scale of investment needed to expand access to energy infrastructure to all citizens. A wide range of policy actions and targeted measures are available to ensure that investment in energy infrastructure boosts economic growth while benefitting the poorest segments of the population. As highlighted in several editions of the *World Energy Outlook* of the International Energy Agency (IEA),¹¹ all available sources of finance will need to be tapped to target the different segments of the population still lacking energy infrastructure, including international funds, public/private partnerships, bank finance at multilateral, bilateral and local levels and microfinance, loans and targeted subsidies. Public sector intervention will need to take the form of loans and leasing finance to convert unaffordable high initial investment costs into affordable operating costs, grants and even initial operating subsidies. In addition, consumer contributions will be critical to the successful uptake of essential energy services. Evidence suggests that households that pay for even a small fraction of the cost of modern energy services are more likely to provide for maintenance and operating costs.

In mature economies, virtually all households have access to electricity and clean cooking facilities, but some cannot afford to pay for adequate heating. This “fuel poverty” is estimated to affect 9.8% of households in the EU27 and 15.8% of households in the 12 new member states (EU SILC, 2011). It is especially prevalent in former centrally planned economies, where vulnerable groups, such as pensioners and the unemployed, can spend as much as 15% of their total income on energy.¹² In the United States fuel poverty affects about 16 million households, of which only about 1 in 3 receives fuel aid.¹³ The main cause of fuel poverty is low household income, but other factors are also important, including the propensity of lower-income households to live in older buildings with poorer heating and insulation standards. Fuel poverty can have severe consequences, a study of 40 000 excess deaths in England and Wales highlighted a potential link between poor housing and poverty and cold-related deaths.¹⁴ Fuel poverty policy in developed economies has focused on two mitigation strategies: i) government or utility subsidy programmes to lower utility or fuel bills,¹⁵ and ii) weatherisation programmes to reduce high energy losses associated with often substandard housing occupied by lower-income households. The latter category of energy efficiency improvements can be particularly effective in reducing fuel poverty, as they permanently lower energy bills for low-income households while saving energy and providing local jobs.

The challenge of delivering an appropriate level of public services in remote areas

Delivering vital services in remote and rural areas can be immensely challenging. The provision of services in these areas carries higher costs to the benefit of a smaller share of the total population. Distances are problematic as transportation and overall costs for the provision of goods and services are higher in rural areas on a per capita basis, and low levels of population and low population density make it hard to achieve a critical mass. Moreover, the aging population structure found in a number of OECD rural areas places additional strain on service delivery. The challenges of providing services in remote areas can contribute to decreased willingness on the part of governments to subsidise rural services, particularly in periods of prolonged fiscal consolidation. In many such areas there is also a severe limitation on the choice of service provider, as there is often insufficient local demand to have numerous providers. This risks creating a situation where providers can “share the market”, facing little pressure to compete or to deliver services in a cost-effective manner. There is also the issue of the weaker communication networks found in rural areas where sparseness and distance lead to relatively simple networks with few connections.

The challenge of reaching an adequate level of public service provision in remote areas is formidable, but there are broad policy strategies that can mitigate access problems. Firstly, it is essential to fully exploit synergies by consolidating, co-locating or merging similar services. There is also an increasing role to be played for alternative delivery mechanisms. The Internet will be particularly key in this regard, as it offers the possibility of providing additional services in rural areas, whilst also allowing providers in rural areas to offer services outside their immediate territory. Renewable energy exploitation can also play an important role, by reducing “fuel poverty” which can be a common feature of remote regions. In addition, innovation in remote area service provision is essential to boosting access to existing services, and can encourage the creation of new services in order to achieve better outcomes. The positive effects of service innovation in remote areas have been felt with the creation of services like the mobile handyman enterprise that operates out of a fully equipped vehicle and is scheduled by telephone or Internet.

In developing countries and emerging market economies, the remote rural population is often the poorest of the poor. Some countries, for example China and Brazil, have nevertheless made successful efforts to bring electricity even to remote areas, and to improve access to all-weather roads. But in developing countries in particular, rural subsistence farmers have typically lived outside the market economy, and still have limited access to electricity, paved roads, clean water or basic health services. As noted above, successful efforts are being made in some countries to make grants for services conditional on keeping children in school. Cheaper and more flexible ways of remitting migrants earnings can also help raise their extended families out of poverty. Inclusive Growth in those countries will entail strong efforts to provide better health, transport and educational facilities for those rural populations.

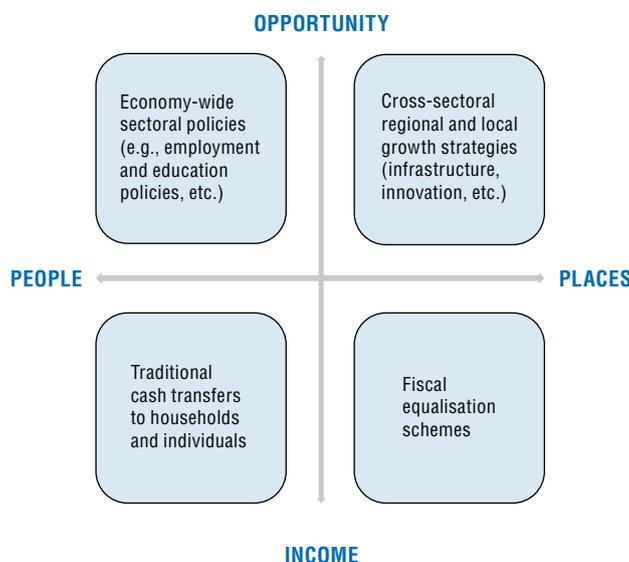
4.6. Acting spatially to foster policy complementarities: Cities matter for Inclusive Growth

Economic and social inequalities have a spatial dimension. As discussed in Chapter 2, income inequality within cities has been rising faster than inequality within countries, essentially due to the skills distribution gap, which is wider in cities. Inequalities among

large regions within a country result mainly from differences in growth rates and the typical policy response is to search for ways of unlocking the untapped growth potential of lagging regions. OECD research points to the potential of a place-based approach to turning around under-performing regional economies (OECD, 2011c and OECD, 2014c). In addition, cities, especially large metropolitan areas, have higher costs of living, particularly because of housing and transport, which lower the purchasing power of low-income groups, forcing them to live in areas with limited access to public transport and job opportunities.

Designing policies to target spatial inequalities requires policy makers to consider the trade-offs and complementarities involved in both the *objectives* they aim to target and the *channels* through which they do so. Addressing income inequalities may encompass both traditional transfers to households – targeting people – and mechanisms aimed at ensuring equity in the provision of public goods and services – targeting places (Figure 4.7). Similarly, policies with the objective of strengthening equal opportunities may be focused directly on households or individuals (economy-wide employment and education policies, for example) or they may involve regional or local development strategies designed to tap the sources of potential growth in specific localities. On average, OECD governments spend about as much on public services with a distinct spatial component as they do on cash benefits and transfers to households.

Figure 4.7. **Targeting inequalities: Objectives and channels**



Purely “people-based” policies – based on personal circumstances and independent of location – can efficiently target resources to poor households, but more is needed to deliver a holistic and sustainable shift towards more Inclusive Growth. In particular:

- **Better access to basic public services**, such as education, health and public safety is fundamental to more Inclusive Growth, and the provision of public services has an intrinsic place-based character. Amenities in cities are rarely distributed evenly, resulting in higher housing prices and rents in areas with good public services, particularly schools. Poor-quality services (especially in education and training) may mean that individuals in

economically distressed places are ill-equipped to pursue opportunities elsewhere or to generate new activities where they are.

- **Mobility** can help address supply and demand mismatches in the labour market, but people may be reluctant or unable to move. Mobility costs include not only transportation and the costs of changing residences but also the possible loss of family links, social networks and other forms of social capital, which are particularly important for people suffering from multiple deprivations. Networks can be important in reducing reliance on services such as child care and elderly care, thus enabling carers – often women – to work.
- **Better design of social housing** can help integrate low-income households in the wider community. Some recent work suggests that not only the quantity and quality but also the *design* of social housing can have a significant effect both on the well-being of residents and on the impact of social housing on surrounding communities. Integration of affordable housing in functioning street networks, for example, appears to be much more promising than the creation of large, physically segregated estates (Box 4.11).

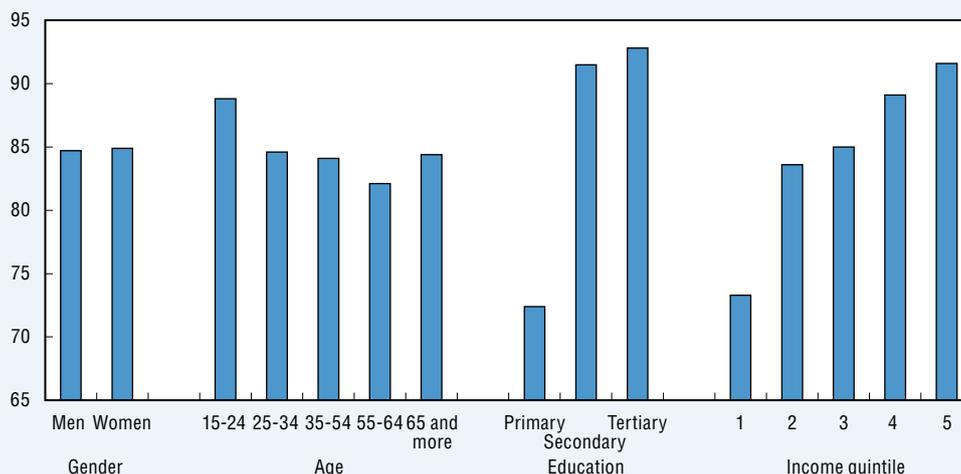
Box 4.11. **Spatial segregation with metropolitan areas**

Socio-economic inequality in urban areas is generally associated with strong residential segregation with the low income populations concentrated in disadvantaged neighbourhoods. In developing countries, migration into poor cities from an even poorer rural hinterland has led to the formation of slums. Slums have been almost eradicated in advanced economies but deprived neighbourhoods have become a major issue in many metropolitan areas in advanced economies, including in the wealthiest cities. In many cases, this is also related to social exclusion of certain ethnic minorities. Poor people living in deprived neighbourhoods typically have poor urban amenities and limited access to public transport and other essential public goods and services. Labour market exclusion can become intergenerational, affecting a wide range of factors including health outcomes – a fact recently demonstrated dramatically in a map showing the variation in life expectancies associated with living adjacent to different metro stops in London (James, 2012).

Where more disadvantaged people are concentrated in one place, problems of relative exclusion can be compounded by an absence of positive social networks and low aspirations among the populations. OECD work has shown that social support networks – an important dimension of inclusiveness – tend to be weaker among the most disadvantaged social groups, including the poor and the less educated. A survey conducted by Gallup World Poll found that on average for OECD countries, about 93% of people with tertiary education report having someone to count on, but only about 84% of people with below an ‘upper secondary’ education have someone to count on (Figure 4.8) (OECD, 2013h). A similar pattern applies between upper and lower income quintiles. While only 73% of respondents in the bottom income quintile report having someone to count on in case of need, the proportion increases progressively with income. On the whole, the residents in distressed neighbourhoods tend to have poorer social networks which can be crucial to employment prospects.

Box 4.11. **Spatial segregation with metropolitan areas (cont.)**Figure 4.8. **In OECD and BRIICS countries, the low educated and the poor have weaker social support**

Number of people (out of 100) who declare that they can count on support from their social network in case of need



Note: Social connections vary substantially across OECD countries. They are measured by the perceived social network support in case of need.

Source: OECD calculations based on Gallup World Poll.

Yet although intra-urban segregation often creates enormous challenges in specific neighbourhoods, neighbourhood-level policy interventions have a mixed track record, at best (see e.g. Cheshire et al. 2008; Mayer et al., 2013; Faggio, 2014). The designation of special zones at the intra-urban scale too easily leads to displacement of activity or to very different treatment of individuals and households whose conditions are in fact quite similar. Thus, while place-based approaches that reflect the conditions of cities are often required, interventions at very small territorial scales need to avoid creating spatial distortions and focus on overcoming spatial segregation via instruments that improve access to opportunity and integrate distressed neighbourhoods into the wider social and economic environment.

The problem of intra-urban spatial segregation is closely linked to that of affordable housing, because many affordable housing policies – particularly the direct public provision of social housing on a large scale – can have the effect of addressing one symptom of exclusion (lack of adequate and affordable housing) while aggravating another (the spatial concentration of the poor). Critics have long tended to link the provision of social housing to the clustering of “social bads” like crime and delinquency in cities, and this has often prompted local resistance to the provision of social housing. However, failure to provide affordable housing can block low-income people out of urban labour markets and cut them off from other urban amenities and opportunities. Fortunately, more nuanced research suggests that better design can help improve both the supply of social housing and its social impact. In many countries, post-war housing estates tended to be designed so that they were, physically, rather inward looking: the aim was to create a sense of community but the result was often to reduce spatial interlinkages with the surrounding city. Moreover, they often created over-complex, and as a result, under-used spaces, which were then populated by, e.g. large groups of unsupervised children and teenagers. This pattern of activity, and the segregation of residents, is not nearly as pronounced in non-estate street networks (Hillier, 2012 and Al Sayed and Hanna, 2013).

Knowledge of local conditions can help policy makers to identify potential synergies among competing objectives and to manage the trade-offs between them that may arise. For example:

- **Policies that improve access to education and training, transport and other essential services** can serve equity objectives, while also supporting growth in a particular place, and they require an understanding of local conditions. For example, policies aimed at improving the supply of affordable housing need to be co-ordinated with transport planning, service provision and labour-market interventions in order to minimise the risk that such policies will result in the creation of ghettos.
- **Active labour market policies (ALMPs)** can facilitate a better match of jobs with skills, thus lowering unemployment and making a strong contribution to social equality. Yet, ALMPs still need a place-based dimension. Policies concerned with improving information about labour-market conditions, or with improving targets for matching, training or subsidising employers are more effective when designed at the regional or local levels, since information about local conditions is crucial to success (Froy and Giguère, 2010).
- **Green growth policies can contribute to more Inclusive Growth in urban areas.** Some urban green growth policies have much potential for fostering employment and innovation (OECD, 2013g). For instance, integrating land-use, transport and economic development planning can contribute to outcomes that are greener (increasing reliance on public transport), more equitable (improving access to labour markets for disadvantaged areas) and more efficient (reducing congestion, commuting times, etc.).

These issues are even more acute in fast-urbanising middle-income and developing countries. Settlement and urban patterns are still changing fast in those countries, so decisions made today can have lasting consequences. Of particular importance is the strengthening of land rights, which are often informal and poorly protected, and the related question of informal settlements which spring up on the fringes of many such cities, often with undesirable social, economic and even environmental consequences.

Sometimes, though, goals compete with, rather than complement, one another. Cities and regions must recognise and manage the trade-offs that may arise among policy objectives, and effective co-ordination of different sectoral policies is important. It is often impossible for national-level policy makers to predict and manage policy trade-offs; local knowledge is often critical to understanding conflicts that may arise, and thus cities often provide the best setting for successful complementary policies. Unco-ordinated efforts to address inequality and exclusion may lead to poor or even perverse results. For instance:

- **Attracting skilled workers** and increasing the share of knowledge-based activities in urban economies might improve labour markets prospects for the high skilled, but this further increases wage difference between low- and high-skilled workers and drives intra-urban inequality. Urban policy makers should also attempt to upgrade the skills of the local low skilled workforce.
- **Regenerating a neighbourhood** may improve opportunities for business and homeowners, but it may also push up rents and displace the disadvantaged. To ensure affordable housing options for low-income households within rapidly transforming neighbourhoods, housing policies, which are often “people-based”, must take the spatial inequality more seriously and co-ordinate with urban development policies.

- New **eco-neighbourhoods** have been open to criticism for an excessively isolated approach (lack of contacts with the existing city) and the effects of gentrification that often go hand-in-hand with their inclusion in the city (Kamal-Chaoui and Plouin, 2012). To ensure that a green growth policy in the building sector contributes to greater social balance, greening policies should focus on social housing, and care should be taken to ensure that energy retrofit projects of neighbourhoods do not penalise residents access to housing.

The “competitive cities” paradigm that prevailed in many places prior to the crisis needs to be rethought. In the past, growth- and competitiveness-oriented urban policies focused above all on the need to create business-friendly conditions to attract footloose investors in a globalising world of mobile capital. While cities clearly need to attract financial and human capital – productive firms and highly skilled people – this paradigm often failed to combine attractive conditions for investment and an improved quality of life in a place.

The competitive cities paradigm may also have often favoured the well-off over the disadvantaged. At the very least, the distributional consequences of growth strategies were given little consideration and in many places there was a tendency (often for political reasons) to favour highly visible investments in physical infrastructure and discrete “development projects” rather than investments in human capital, essential services and quality housing. Policy makers should focus more seriously on integrated strategies for cities, rather than about discrete interventions that address the needs of specific constituencies.

Integrated, place-based approaches also give cities sufficient freedom and flexibility to adopt and implement packages that reflect their particular conditions and needs. Even where policy frameworks are set by national governments (e.g. active labour market policies), cities need the freedom to implement them in ways that reflect local needs and meet local strategic objectives agreed on in partnership. A focus on locally flexible policy-management frameworks would provide local city agencies, including branches of national governments, with a greater say in how interventions are designed, budgets are managed, performance targets are set and activities are outsourced, all within the limits set by accountability requirements (OECD, 2009b, Froy et al., 2011). Initiatives to address skills mismatch, including through training of low income populations and ethnic minorities, can also be better addressed at the urban scale (OECD, 2009a) (Box 4.12).

Greater co-ordination is also required across city jurisdictions. Ideally, the provision of public goods should be governed at a high enough level to reduce the disincentives to providing “common goods”. Transport and land-use planning, in particular, can result in extremely poor outcomes for both efficiency and equity where co-ordination across jurisdiction is lacking. These issues suggest governing cities as functional economies rather than administrative units. Even relatively modest-sized urban agglomerations are often quite fragmented from a political-administrative perspective. Evidence suggests that leadership from higher levels of government is often required to bring about cross-jurisdictional co-operation among municipalities that is needed in complex metropolitan areas.

Finally, national governments may also need to become better at “city-proofing” their national policies to ensure that they do not have unintended urban effects. National governments could inject more local flexibility in managing active labour market policies

Box 4.12. Making full use of local skills

In the **United Kingdom**, larger cities have been awarded “City deals”- agreements with government that give each city an enhanced role in decision making and greater responsibility in deciding how public money should be spent. This has allowed cities to think more innovatively about how they address social and economic exclusion, while also working towards economic growth. The first wave of City Deals were with the 8 largest cities outside of London (Bristol, Birmingham, Nottingham, Manchester, Sheffield, Liverpool, Leeds and Newcastle), and a second wave involves a further 20 cities. Increased flexibility in the implementation of skills policy has allowed Manchester, for example, to set up an Apprenticeships and Skills Hub that has created 2 755 apprenticeships in SMEs.

In **Canada**, the multi-level Canada-Ontario-Toronto Memorandum of Understanding on Immigration and Settlement creates a partnership with the City of Toronto on immigrant-settlement matters. The MoU outlines tri-level co-operation on key issues related to integrating immigrants into the metropolitan economy and society, including access to housing and other settlement matters, as well as the all-important language-training issue. It establishes a clear framework for full participation by the City of Toronto in the oversight of settlement and language-training programming whose membership was previously restricted to the Province and the federal government.

Also involving Toronto, the Toronto Regional Immigrant Employment Council (TRIEC) was established. It brings together multiple stakeholders – employers, regulatory bodies, professional associations, educators, labour, community groups, government and immigrants. Led by the Toronto chamber of commerce, the TRIEC addresses the issue of how to recognise the skills and credentials of immigrants – who represent a significant and increasing proportion of the working-age population in the Metropolitan Region - in a way that allows them to obtain long-term employment in occupations for which they have been trained. The issue of credential recognition is a key stumbling block in semi- and high-skilled workers’ efforts to obtain initial Canadian work experience. Without Canadian work experience, it becomes that much more difficult for an immigrant to enter the Toronto labour force in the field in which s/he has been trained.

TRIEC’s work focuses on increasing access to services and programmes that help skilled immigrants effectively enter the local labour market, working with key stakeholders, particularly employers, to build their capacity to work better with skilled immigrants; and working with all levels of government to increase local co-ordination of public policy and programming. This benefits all stakeholders: employers benefit from improved recruitment channels, and access to new distribution; potential employees benefit through building their professional connections and experience through mentoring; educational institutions benefit from help with the development and distribution of learning tools and the curriculum, and finally government benefits through increased support from the private sector and independent interaction between those that supply and those that demand labour force skills. TRIEC relies heavily on the support of mentors within the business community, this can include immigrants who have successfully integrated with the labour force and former “mentees” – graduates of TRIEC’s mentorship programme. These mentoring schemes fulfil the dual role of enhancing the networks of new immigrants, whilst at the same time providing them with role models to focus their aspirations.

Sources: OECD (2009a), *Designing Local Skills Strategies*, Local Economic and Employment Development (LEED), OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264066649-en>; OECD (2012), *OECD Territorial Reviews: Skåne, Sweden 2012*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264177741-en>; OECD (2012), *OECD Territorial Reviews: The Chicago Tri-State Metropolitan Area, United States 2012*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264170315-en>; OECD (2014), *Job Creation and Local Economic Development*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264215009-en>; OECD (2006), *From Immigration to Integration: Local Solutions to a Global Challenge*, Local Economic and Employment Development (LEED), OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264028968-en>.

(OECD, 2009b). Local employment agencies can have more discretion in how interventions are designed, budgets are managed, performance targets are set and activities are outsourced, within the limits set by accountability requirements. Research by the OECD *LEED Programme* has shown that when such flexibility is awarded, local employment

agencies become more active partners in city strategies to address unemployment and social exclusion (OECD, 2009b and Froy et al., 2011). Similar incentives are needed in other policy areas, including education and training, housing and immigration. Furthermore, there is a need for more extensive monitoring and evaluation of national and city-level initiatives aimed at fostering Inclusive Growth (OECD, 2013k). There is no clearly-defined “best practice” in this field, and experimentation and innovation are badly needed.

4.7. Adapting development policies faced with poverty and inequality

Structural change and Inclusive Growth

Fast growth of GDP in several non-OECD countries has lifted millions out of poverty, but challenges remain if continued growth is to be more inclusive. The last decade has seen patterns of growth changing across the world, as the centre of economic gravity shifted from Western countries towards the East and the South (OECD, 2010c). This “shifting growth” process, driven by China’s rise and integration with the global economy, has directly and indirectly fuelled economic growth in many other countries. Often, these changing patterns of growth have been accompanied by both major increases in productivity and substantial falls in poverty. One of the biggest challenges for policy makers around the world continues to be the identification of strategies that promote economic growth accompanied by continued reduction in poverty and the creation of well-paying jobs for all those who wish to work.

Strong, jobs-rich growth is a necessary step towards Inclusive Growth. This is because employment is still the best means for individuals to boost incomes, and improve material and non-material living standards. Economic development usually entails shifts of labour from a low-productivity agricultural sector and/or low-productivity activities to higher-productivity, more skill-intensive activities in manufacturing and services. In the case of China, most of the very high productivity growth of the last decades has resulted from productivity gains within manufacturing, although labour migration from low to high-productivity sectors has also been significant. By contrast, in India, the two forces were of about equal importance. At the other extreme, within-sector productivity developments in Turkey had a negative impact on overall productivity growth, possibly because higher-skilled workers moved to other sectors where their skills could be put to better use (Figure 4.9).

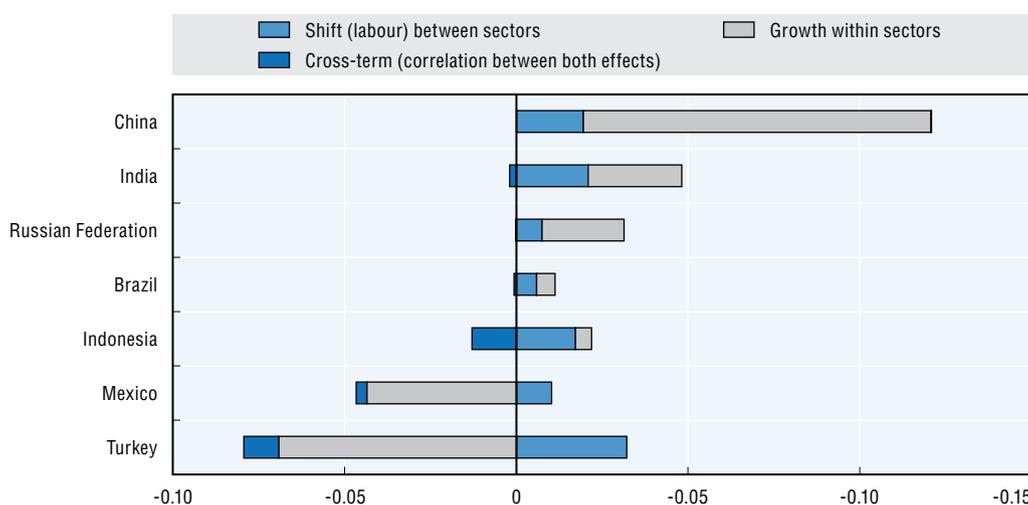
Labour productivity gains through industrialisation can be further enhanced by reaping the demographic dividend. Rising *per capita* incomes in developing countries have typically been accompanied by falling birth rates. When families have fewer children, the number of non-productive dependents falls while the share of those of working age in the population increases. The combined effect from a larger labour force that is employed in more productive activities yields a double dividend. However, if productivity rises faster than demand for the products, perhaps reflecting rigidities in labour and/or product markets, unemployment or underemployment will be the result. Taken together, the benefits of labour shifts and demographic change, as well as the challenges from underemployment, are all linked to the importance of economic (productivity) growth and job creation.

Countries can facilitate structural transformation through policies that boost productivity in low-productivity sectors, and facilitate movement of labour to high-productivity sectors. In the early stages of development a large share of the population is still engaged in low-productivity agricultural activities. Agriculture is still of enormous

importance in most developing countries, the poor are concentrated in rural areas, and most of the extremely poor rely on subsistence farming for their livelihoods. Many developing countries still have significant potential to increase agricultural productivity, for example through mechanisation and investments in more advanced seeds and fertilisers, which can help to free up labour that can then move into other, more productive activities. Smallholder farmers, in particular, face numerous constraints to productivity growth, as discussed above, due to limited access to credit and insurance, as well as land tenure insecurity. Integration of smallholder farmers into vertical value chains can support agricultural productivity. Examples of successful commercialisation of agricultural products are cocoa production in Ghana, or vertically integrated fruit production in Kenya (OECD, 2013b). Typically, the freed-up labour moves first into low-skill labour-intensive manufacturing in urban areas, which calls for the provision of basic infrastructure and other public services, as well as affordable housing, to make the industrialisation-urbanisation process more inclusive.

Figure 4.9. Shifting labour to more productive sectors spurs growth

Shift-share decomposition of labour productivity growth, annual average over 2000-2009



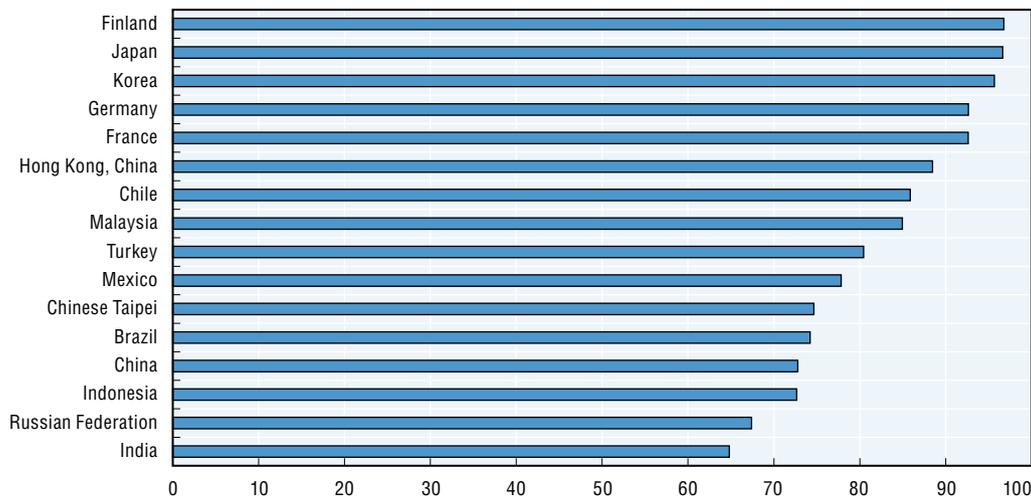
Note: Figure based on 32 sectors including agriculture, mining, 14 manufacturing and 16 service industries in 39 economies. Productivity is measured by value added in 2002 constant US dollars per person employed. The within-sector effect measures the impact of productivity growth within each sector on total economy productivity growth, assuming that sector labour shares are unchanged. The shift effect measures the impact on total economy productivity resulting from the movement of labour between sectors, assuming that the level of productivity in each sector is unchanged. The cross-term effect measures the change in both labour share and productivity in each sector and accounts for the impact of labour re-allocation between sectors with varying productivity growth rates.

Source: OECD calculations using the *World Input-Output Database*. Timmer, M.P (ed.) (2012), "The World Input-Output Database (WIOD): Contents, Sources and Methods", *WIOD Working Paper*, No. 10.

Once the potential of shifting labour out of low-productivity agriculture is exhausted, moving workers from low to high-productivity activities becomes more important. One route is to move up the productivity scale in manufacturing, often by adopting and adapting more sophisticated technologies developed in advanced countries, as discussed above. Relative to the United States, the benchmark country for productivity in manufacturing, emerging market economies still have some way to go (Figure 4.10). As well as involving the creation of new industrial sectors and upgrading of products in existing value chains based on comparative advantage, moving up the productivity ladder also requires strengthening the service sector, which has significant potential to absorb both low and high-skilled labour.

Figure 4.10. There is still ample room for manufacturing industries in emerging market economies to catch up with productivity levels in the United States

Manufacturing total factor productivity relative to the United States, weighted average over 2002-09



Note: Average manufacturing TFP 2002-09, weighted by value added in 14 sectors classified according to the International Standard Industrial Classification Revision 3 (ISIC Rev. 3).

Source: OECD's estimations using the United Nations Industrial Development Organization (UNIDO) *Industrial Statistics and the World Input-Output Database*. Timmer, M.P. (ed.) (2012), "The World Input-Output Database (WIOD): Contents, Sources and Methods", *WIOD Working Paper*, No. 10.

Policies need to focus on both raising productivity and ensuring that the labour force is equipped to deal with it. Small young firms display stronger productivity growth than old large firms (OECD, 2014a), but new firms, small firms and those in the services-sector often have limited access to finance. New service-sector firms in particular often have limited access to finance. Governments can set up credit guarantee schemes to encourage credit creation and can generally foster entrepreneurship to mitigate the disadvantages of such firms. Governments should also provide targeted education (including vocational and on-the-job training) to prepare for a transition towards higher productivity industrial activities and ICT-based service activities. It is important to provide the right kinds of skills, for example, in many African countries, the university system traditionally focused on providing education for public sector jobs (OECD, 2012a). Adapting educational curricula to market needs is necessary, and governments can support on-the-job training to bridge education mismatches. Developing countries should focus vocational training on sectors and competencies where training would have the strongest employment impact, and establish a clear and widely understood system of skills certification to promote transparency and boost the employability of graduates.

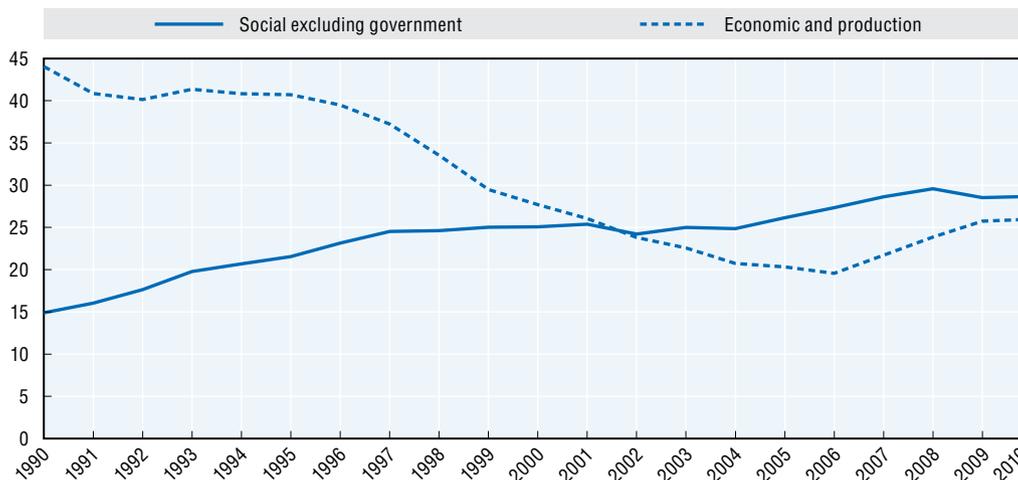
Can development aid support Inclusive Growth?

Aid can support Inclusive Growth by helping to get the enabling conditions right and through targeted interventions, in particular to those living at the fringes of society and in the poorest countries. While the overall empirical correlation between aid and Inclusive Growth is difficult to assess, on balance the cross-country evidence suggests that aid has a positive, albeit small, effect. Inclusive Growth has become a priority in developing country strategies and donors are responding with tailored support in areas such as agriculture, private sector development, health and education. Aid will remain essential, especially in low-income countries, in supporting domestic policies and structural transformation to achieve Inclusive Growth.

The focus of development aid has changed over the decades as lessons are learned and problems facing poorer countries evolve. Since the beginning of the century, the Millennium Development Goals programme helped orient aid towards poverty reduction, health and education, a “pro-poor growth” approach.¹⁶ The experience of the BRICS countries, which had concentrated their development efforts on growth *per se* and lifted many of their citizens out of poverty, encouraged the G20 to call for an agenda fostering “strong, sustainable, inclusive growth” (G20, 2009). The G20 define Inclusive Growth as growth which creates jobs, coupled with social policies and legal protections, involving civil society, NGOs and the private sector. Consequently, and especially since the global crisis, OECD aid donors have started to commit relatively more aid towards economic development, although social aid remains paramount, as has been the case since the beginning of this century (Figure 4.11). In addition, Inclusive Growth objectives will help frame the Post-2015 Development Agenda (Box 4.13).

Figure 4.11. The share of ODA dedicated to social spending has exceeded that for economic development since 2003

% total ODA, three-year average commitments



Source: OECD (2013e), *Development Co-operation Report 2013: Ending Poverty*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/dcr-2013-en>.

Aid can help foster Inclusive Growth, but important challenges need to be addressed. Aid helps to support government capacities, address infrastructure deficiencies, and improve education, health care and social protection systems for the poor. These areas are especially important in the poorest, most fragile and conflict-affected states. For such countries, official development assistance (ODA) accounted for over 60% of external financing over the 2005-2010 period (by contrast, for middle income countries, ODA represented a mere 4% (Adugna et al., 2011). Because of the wide variations in aid per inhabitant, the different goals at which aid is aimed, and the comparatively small amounts involved (USD 31.5 per capita per year according to Tarp (2006), it is not easy to quantify the impact of ODA on growth. However, Arndt et al. (2010) finds that ODA equivalent to 1% of GDP raised GDP growth by 0.1% on average over the 1970-2000 period, a small but helpful impact. Clemens et al. (2012) found that increases in aid are usually followed by increases in investment and growth, although the magnitude of this relationship is modest, and it varies greatly across recipients and diminishes at high levels of aid. Similarly, studies on the role of ODA in assisting Inclusive Growth by reducing poverty and promoting health

and education have been positive, but with room for improvement (Collier and Dollar, 2002; Bourignon and Sundberg, 2007; Virtanen and Ehrenpreis, 2007; Alvi and Senbeta, 2012). Also, Huang and Quibria (2013) find that foreign aid has a positive impact on Inclusive Growth in their sample of countries, especially when aid is directed at the areas of health and education.

Box 4.13. Addressing Inequalities in the Post-2015 Development Agenda

The international community, under the leadership of the UN, is currently discussing a new global development agenda. This will focus on a specific set of goals for “poverty eradication and sustainable development” building on the progress already achieved through the Millennium Development Goals (UNGA, 2013).

Today, almost 80% of those living on less than 2 US dollars a day reside in middle-income countries. Despite impressive economic growth in recent years and substantial improvements in health and educational outcomes, growth has been a necessary but not sufficient condition for poverty reduction – growth needs to be more inclusive.

Inequality is also related to sustainability. As mentioned in Chapters 2 and 3, OECD research suggests that increasing inequalities erode social cohesion, stifle upward social mobility, threaten equality of opportunities and generate political instability (OECD, 2011d). Given its prime importance for the future of poverty reduction and sustainability, tackling inequality in its many dimensions (income, political, gender etc.) is crucial for achieving global goals.

There are several areas where aid could make a significant difference in making growth more inclusive. In particular:

- **Expand access of the poor to vital and proven technologies**, such as high-yield seeds, immunisations, modern contraception or Internet connectivity (Sachs, 2005). Easterly (2006) notes that such interventions “give the poorest people the health, nutrition, education, and other inputs that raise the payoffs to their own efforts to better their lives”.
- **Identify barriers to growth and take steps to increase the inclusiveness of the growth process**, for example by increasing processing of raw materials and not just their extraction (where this makes economic sense) and by providing infrastructure that helps the poor to access markets (OECD, 2007).
- **Improve the business environment, provide market information and infrastructure while cutting red tape**. The significant risks to doing business in developing countries, especially the fragile and conflict-affected states, can be mitigated via loan guarantees and other debt and equity instruments.
- **In the short term, there remains a need for aid-supported social protection**. Micro-insurance schemes have their uses, although they might not be the most appropriate social protection mechanism for the poor. There have been many positive experiences with Conditional Cash Transfer Programmes (CCTs) on school enrolment rates, reduced school drop-out and improved health and clinic attendance. CCTs are “as close as you can come to magic bullet in development by creating an incentive for families to invest in their own children’s futures”.¹⁷

- **Effective democratic governance is a pre-requisite for Inclusive Growth.** Aid that improves government accountability and citizen-state relations can help reduce poverty and support rights, equity and justice, in particular for marginalised populations. Donors can help through technical assistance focusing on electoral processes, the strengthening of legislatures and judiciaries as checks on executive power, and the protection of civil society organisations, including a free press (Knack, 2004).
- **Aid should foster complementary and coherent policies for inclusive and sustainable growth.** Aid can promote renewable energy, low-carbon transportation networks, clean water, waste disposal and sewage treatment, sustainable agriculture and drought-resistant crops; thereby improving economic opportunity, energy access, and public health and sanitation for the poor. Furthermore, aid for capacity building in the areas of eco-system services schemes, environmental fiscal reform and fuel subsidy reform helps meet environmental goals. If savings and revenues are invested in health, education and poverty programmes, environmental and social objectives can be achieved simultaneously.

Notes

1. National Bureau Statistics China.
2. See for example Moreno, L. (2007), “Extending Financial Services to Latin America’s Poor”, McKinsey Quarterly 83, 90.
3. This study was to some extent inspired by the seminal study from Australia: Creedy J. & Dixon, R. (1998), “The Relative Burden of Monopoly on Households with Different Incomes”, 65 *Economica*.
4. See for instance, Bassanini and Duval, 2006; Griffith et al., 2007; Nicoletti and Scarpetta, 2005; Fiori et al., 2007; Nicoletti et al., 2001.
5. If there is lack of competition all along the supply chain, for example if there is a monopoly importer of a cereal, selling to oligopolistic manufacturers, who sell the final product to duopolistic supermarket chains, imposing competition on only one link in the chain might not make much difference, if any, in retail prices. Attacking all links in the chain might be beyond the resources of the competition policy authorities (OECD, 2013d).
6. Labour Force Survey.
7. OECD Institutional Investors Database. www.oecd-ilibrary.org/finance-and-investment/data/oecd-institutional-investors-statistics/oecd-institutional-investors-statistics_data-00498-en.
8. www.investopedia.com/terms/m/mid_cap_fund.asp.
9. In this context “efficient” means: cheaper, safer, more frequent, with greater carrying capacity, etc.
10. In practice, commuters often react to faster intra-urban transport facilities by moving further from city centres to take advantage of lower land prices and more attractive surroundings.
11. See in particular IEA (2010) special excerpt “Energy Poverty: How to make modern energy access universal” and IEA (2011) special excerpt: Financing access for the poor.
12. Can poor consumers pay for energy and water? An affordability analysis for transition countries, Samuel Fankhauser and Sladjana Tepic, EBRD 2005.
13. “Fuel poverty in the USA: The overview and the outlook”, Dr. Meg Power, Reprinted from: Energy Action Issue No. 98, March 2006.
14. Cold Comfort: The Social and Environmental Determinants of Excess Winter Death in England and Wales”, Paul Wilkinson, Ben Armstrong, Megan Landon et al. published by The policy Press, UK, 2001.
15. www.pge.com/myhome/customerservice/financialassistance/.

16. The OECD DAC Network on Poverty Reduction (POVNET) produced a number of recommendations on how donors could support Inclusive Growth in areas such as agriculture, infrastructure, private sector development, employment generation and social protection (OECD, 2007).
17. Birdsall, N. (2004), in C.W. Dugger, "To help poor be pupils, not wage earners, Brazil pays parents", *New York Times*, 3 January.

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Chapter 5

Implementing inclusive growth: The role of governance and institutions

What are the political-institutional obstacles to implementing Inclusive Growth policies? How can reform of governance structures and practices help to ensure that administrative barriers to inclusiveness are overcome? This chapter delves into the question of how governing and administrative bodies can be adapted to support the promotion of Inclusive Growth. In particular, the chapter considers how inclusiveness can be embedded in the policy process, examining a number of proposals: from efforts to improve voter participation, to tools for evidence-based policy making, and public consultations. The chapter also appraises strategies for building more inclusive institutions, considering the likely impact of technological change and reform on efforts to make inclusive institutions happen.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Previous chapters made a good case for policies to make growth more inclusive. Empirical analysis and good practice support a rich set of Inclusive Growth policies. What stands in the way of their adoption? The answer relates, in part, to institutions. Policies to promote Inclusive Growth with the depth, consistency and persistence necessary to counteract the forces that reproduce inequality come from strong, inclusive institutions. The latter, however, do not exist in a void. They are shaped by history and by the political, social, and economic environment in which they currently operate. They may be inclusive, support dialogue, creativity and change or they may be rigid and foster exclusion.

A variety of obstacles hinder the emergence of inclusive institutions: inadequate representation of stakeholders, the “capture” of the policy dialogue and policy benefits by narrow interests, inaccessibility of information and obstacles to civic participation, a dominance of informal institutions (e.g. corruption) over formal ones, etc. Fortunately, mechanisms exist to overcome these obstacles and to encourage inclusive institutions, inclusive policy making, and ultimately more inclusive outcomes. This chapter elaborates on these mechanisms as well as institutions and policy processes that support the development and implementation of policies for Inclusive Growth.

5.1. Integrating inclusiveness across the policy cycle

Inclusive politics: Giving voice to all

Opportunities for citizens to participate in and influence policy decisions improve trust in government and increase the likelihood of inclusive policy outcomes. Citizen engagement, access to information, and open government can help render policy making more inclusive and informed, facilitating the design and implementation of policies that are closer to citizen’s needs (Kim, 2010; Kweit and Kweit, 2007). Personal involvement in the policy process strengthens perceptions of legitimacy of the process, which can be as important for citizens as the policy itself (Esaiasson et al., 2012; Hibbing and Theiss-Morse, 2001). The ability of civil society to hold governments to account contributes to increased trust in government (Knack and Zak, 2003). In short, citizen and stakeholder engagement can help legitimise resulting policies, in turn increasing citizen ownership and overall trust in government.

Voter participation and adequate representation

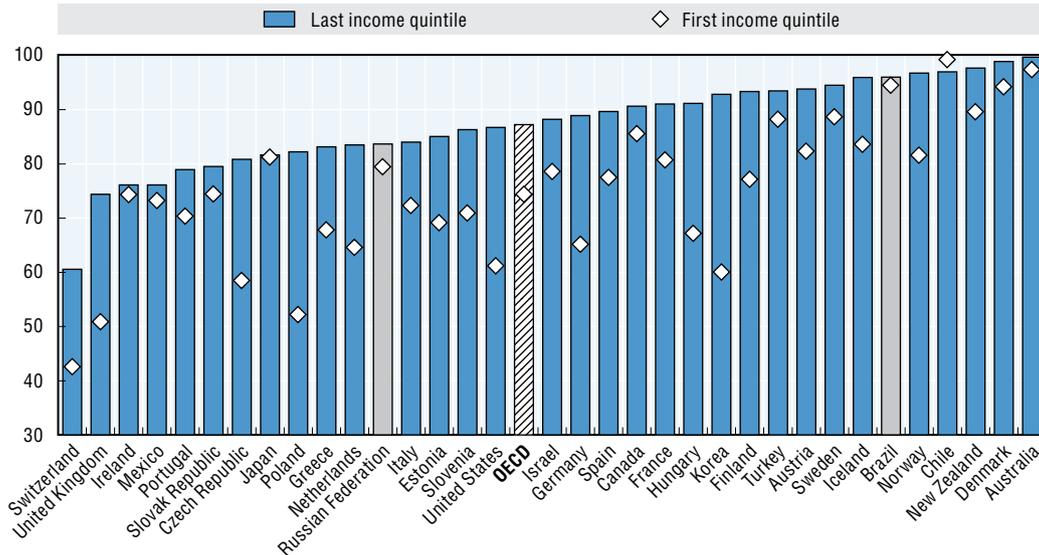
Achieving inclusive policy outcomes depends greatly on whether policies reflect and integrate perspectives of diverse stakeholders. Indeed, there is evidence that when public decision-makers closely represent the societies they serve (i.e. parity between men and women, as well as other groups) they enjoy greater public trust and bring attention to important socio-economic issues. Diversity increases the attention to issues like human development, gender-based violence, family-friendly policies, equal pay, pensions, electoral reform and public service delivery. These matter for the well-being of citizens and may be particularly effective at empowering vulnerable groups.¹

There are broad disparities in civic engagement across countries and among communities. Political and socio-economic inequalities have a strong tendency to reinforce one another, given that governance and political institutions, which determine the distribution of power in society, strongly affect the economic positions of individuals.² While citizens in OECD countries enjoy fundamental civic rights, they may not necessarily exercise them effectively, for instance, through voting. Among OECD countries, voting rates are highest in Australia, where voting is compulsory, and lowest in Switzerland. Many OECD countries experienced declining voter turnout over the last three decades. The decline in civic participation is less visible in some emerging countries where the voter turnout has increased sharply since the mid-1990s (OECD, 2011a; 2013b).

Disparities in voter turnout may reduce the policy influence of the poor, less educated and youth.³ In OECD countries, the differences in voter turnout between rich and poor are particularly large in Korea, Poland, Switzerland, the UK and the United States. By contrast, discrepancies are small in Chile, Ireland and Japan (Figure 5.1). There are also differences in voter turnout by age and educational attainment. Across OECD countries, voter turnout is 12 percentage points higher for people with tertiary education than for those with less than secondary education. Young people typically report lower participation rates in elections than people aged 65 and over (OECD, 2011a). This can lead to unequal representation among various parts of the population and a weakened electoral process, which is (or should be) an effective mechanism for mobilising and giving voice to “outsiders” who lack organisational and financial resources.

Figure 5.1. **Voter turnout rates by country and income level, 2009**

Percentage of votes cast over the registered population, 2009 or latest available year



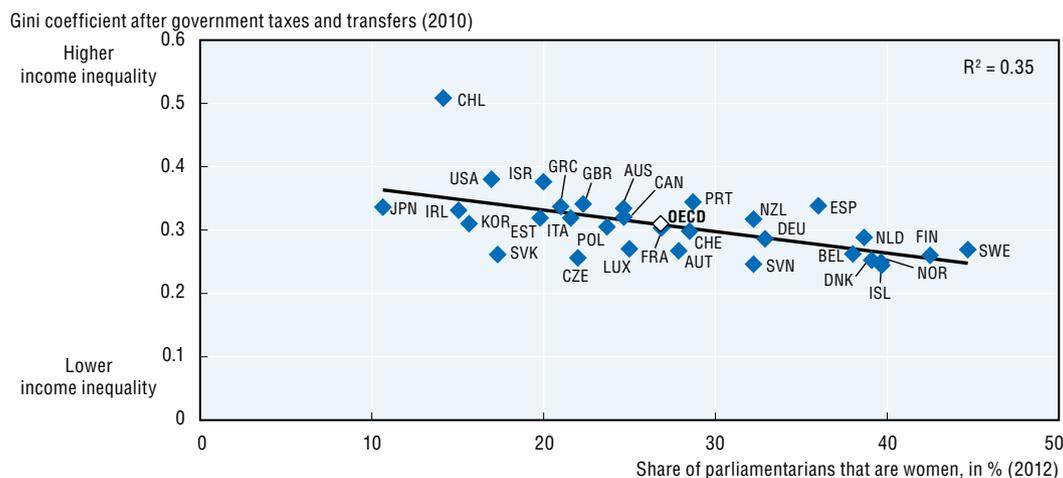
Note: Data refer to 2011 for Estonia, Finland and Turkey; 2010 for Brazil, the Czech Republic, the Netherlands, the Slovak Republic; 2008 for Austria, Canada, Korea, New Zealand, Slovenia, Spain and the United States; 2007 for Australia, France, Ireland, Japan, Poland, Switzerland; 2006 for Israel, Italy, Sweden; 2005 for the United Kingdom; 2004 for the Russian Federation; 2003 for Belgium; 2002 for Hungary and 2001 for Denmark.

Source: OECD (2013a), *How's Life? 2013: Measuring Well-being*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264201392-en>.

Women's civic and political participation helps to promote their own rights as well as those of their families and communities. Women's civic activism pushes governments to be more responsive to women's claims and adopt gender-responsive policies. These policies must take into account the existence of discriminatory social institutions that can restrict

women's ability to actively participate in public life. In some countries this includes limits on women's freedom of movement and negative attitudes towards female involvement in public life. Indeed, there appears to be a negative relationship between representation of women in parliaments and income inequality in OECD countries (Figure 5.2).

Figure 5.2. **Number of women in parliament is linked with country income inequality**



Notes: Gini coefficient: Data for Chile, Ireland, Japan, New Zealand and Switzerland are for 2009. Share of parliamentarians that are women: data refer to share of women parliamentarians recorded as of 31 October 2012. Percentages represent the number of women parliamentarians as a share of total filled seats in the lower or single house of Parliament.

Source: OECD Income Distribution Database and Inter-Parliamentary Union (IPU), PARLINE (database).

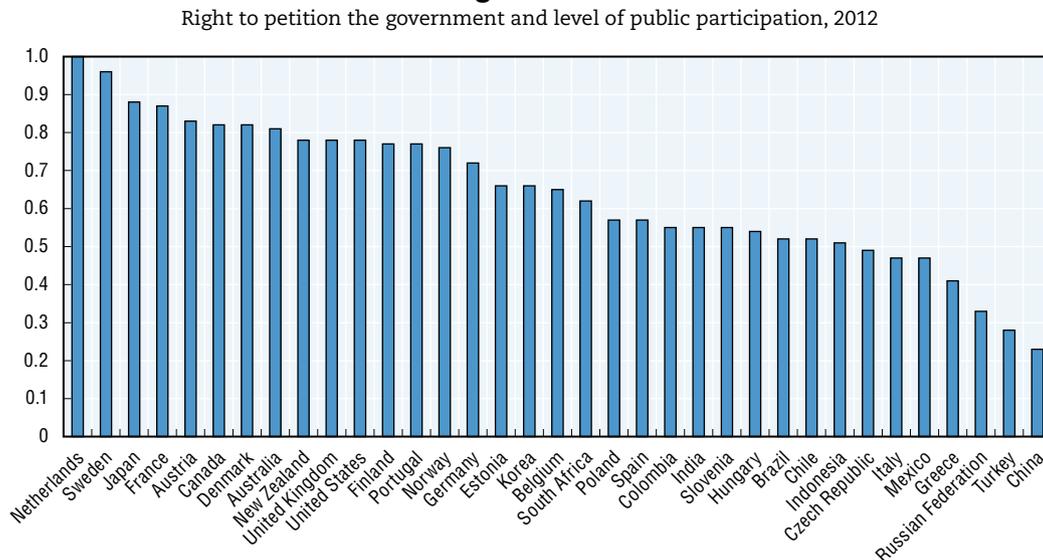
Worldwide, women tend to be underrepresented in legislative and executive positions. This underrepresentation can adversely impact the fairness and inclusiveness of public policies. On average, in OECD countries women hold only 27% of seats in lower or single houses of parliament (a few percentage points higher than the world average of 21.8%). This represents an increase of 6 percentage points on average compared to 2002 (OECD, 2013b). Similarly, women remain underrepresented in leadership positions in the public sector. Although there is notable variation among countries, on average women hold only 29% of top management positions in central government in the 19 OECD countries for which data are available. Developing countries and emerging market economies have made notable headway in increasing the participation of women in politics. In fact, developing countries include ten of the twenty countries with the highest representation of women in national legislatures (IPU, n.d.). Yet much progress remains to be made. For example, in Sub-Saharan Africa, women represent 22.9% in single or lower house, in Asia – 18.9%, and in Arab states – 17.8%. The OECD countries included in these top twenty countries are the Scandinavian countries, Belgium, Germany, Iceland, Netherlands and Spain.

Access to information and civic engagement

Inclusive governance and inclusive outcomes go beyond voting and elected representation. Public officials should also be held accountable between elections. Such accountability requires citizens to have access to information as well as to engage in discussion and action. To this end, a number of mechanisms are available in many countries to facilitate fair and equitable access to information and provide opportunities for citizens' engagement in the policy-making process. These mechanisms include the right to petition government for information (Figure 5.3), freedom of information laws, policy enquiry

commissions, high-level social partnerships, referenda and more recently, two-way citizen engagement mechanisms driven by information and communication technologies.

Figure 5.3. **Countries vary in levels of public participation and right to petition the government**



Source: 2012 Rule of law Index of the World Justice Project.

Access to information extends to public budgets as well. Traditionally, budgeting processes have been complex and opaque, with key decisions made internally within the public administration. Although budgetary institutions vary considerably across countries, a more transparent and inclusive approach should allow budgetary choices to be made manifest to citizens and other stakeholders. It can also activate the role of parliament in engaging with government on the trade-offs involved. The OECD's *Principles on Budgetary Governance* put the issues of transparency and inclusiveness within the context of a sound overall budgeting framework, as an essential element of good public governance more broadly.

Embedding the policy-making process with mechanisms that safeguard the public interest and curb the undue influence of money and power is essential to fairness in policy making. The relationship between inequality and undue influence in politics through political financing is often overlooked. Socio-economic inequality is only the tip of an iceberg of inequalities of different dimensions, including differences in influence, power and voice. Consequently, governments are expected to proactively address high-risk areas at the intersection of the public and private sectors, including lobbying, conflict of interest in public decision making, and the influence of vested interests exercised through political financing. In-depth analysis of facts and comparative evidence on political finance and its associated risks to the fairness of policy making is still needed to understand risks and opportunities in different institutional settings and move away from an ideological discussion.

Decentralisation is crucial to strengthen local voice

Decentralisation has long been seen as one way to empower people, by making the decisions that affect their lives closer to them. There are a number of well-known arguments about why some degree of decentralisation of decision-making would be efficient, including variations in voter preferences across the territory, the potential benefits of inter-jurisdictional competition and information asymmetries between policy makers and citizens (Oates, 1972; Tiebout, 1956; Hayek, 1945). The key argument for

decentralisation is that it is unlikely to be efficient for national governments to plan and manage investment and service delivery “at street level” across the whole country. Higher levels of administration often lack technical and “soft” information about local needs and conditions, which is not readily communicated in quantitative or other standardised forms (Hooghe and Marks, 2009). Such information can be expensive to gather, communicate and verify, and the costs of doing so tend to increase with distance. In contrast to spatially blind or sectoral approaches, place-based policies seek not only to mobilise local information about individual decisions or investments, but they also aim to identify synergies or trade-offs that must be managed effectively (OECD, 2011c). This is particularly important because Inclusive Growth policies require a deliberately multidimensional approach, capable of managing trade-offs and exploiting potential complementarities among different lines of policy.

Research suggests important benefits of decentralisation with respect to the allocation of public resources and delivery of services (OECD, 2013e). Benefits accrue particularly in areas where public services are directly related to where people live (transport, land use, garbage collection); where communities may have distinct preferences over public goods and services (recreation, community services), or where economies of scale in the delivery of public services may be very limited (education, primary health care). For decentralisation to contribute to such outcomes, however, governance structures need to be particularly aligned. Inclusive institutions, including consultation and accountability to the community, are especially important for efficiency purposes when communities have different preferences and subnational governments have the flexibility to reallocate resources across local services. Still, as the dynamics of political competition, public accountability, and the presence of incentive-compatible constraints on government power are not sufficiently understood, care must be taken to ensure that decentralisation does not entrench, rather than mitigate, inequalities.⁴

Successful decentralisation implies responsibilities for all levels of government. Decentralisation is not a zero-sum allocation of competencies across levels of government; rather, empowering regional and local governments may require new competencies and capacities at all levels of administration. Interdependencies are inevitable and co-ordination among levels of government (discussed later) plays an important role in making decentralisation work. When it comes to Inclusive Growth, this points to the need for national governments to pay attention to the potential impact of decentralisation on horizontal equity (e.g. via fiscal equalisation mechanisms or targeted support for specific places) and, where necessary, to support the capacity-building needed to ensure that decentralised decision-making and service provision do not aggravate spatial disparities (OECD, 2013d). Financial, administrative and other capacities vary across space and tend to reflect the distribution of population, wealth and human capital (Box 5.1). Decentralisation should be approached thoughtfully in countries where institutions are comparatively weak and where the disparity in institutional capacities between higher and lower levels of government is particularly marked.

There is no single model of decentralisation that is most conducive to Inclusive Growth. OECD work has recently focused on the need to adapt institutions to places (OECD, 2014a). This may imply a need for “asymmetric decentralisation”. Asymmetric structures can arouse controversy –uniformity is often easier to defend on equity grounds– but when power and other resources are unevenly distributed, asymmetric approaches may result in more inclusive politics and give voice to those who previously felt marginalised.

The current French agenda of territorial and decentralisation reforms aims precisely at developing a more “adaptive strategy” for institutional frameworks which consists in allowing the creation of specific models of governance in particularly complex functional areas, like Marseille and Lyon. The UK’s asymmetric decentralisation of authority to devolved bodies in Scotland, Wales and Northern Ireland is now almost two decades old and continues to evolve. In Spain, too, some of the Autonomous Communities (Catalonia, the Basque Country, Valencia, Andalusia, Navarre and Galicia) have been granted greater autonomy than others, out of respect for nationalist feelings and the rights these regions have enjoyed historically. In Italy, five regions enjoy a special status conferring broader powers over legislation and financial affairs. In recent years, Italy has also been pursuing a metropolitan governance reform that will allow for a range of governance models adapted to the needs and circumstances of different metropolitan areas.

Box 5.1. Encouraging inclusive cities

Cities present unique challenges and opportunities when it comes to pursuing Inclusive Growth policies. With respect to institutions, two challenges linked to spatial inequality stand out:

- **Metropolitan fragmentation.** Many large conurbations constitute functional economies but are politically fragmented, being comprised of a large number of municipalities. In many cases, this complexity is compounded by the presence of numerous “special purpose governments”, such as school districts, transport authorities and the like. The greater Chicago metropolitan region, for example, encompasses some 1700 distinct governmental authorities. This raises clear challenges in terms of efficiency and growth, since it can make it hard to tackle strategic issues like transport and land-use planning at the appropriate scale. It also presents a challenge for equity and inclusion, since such fragmentation often reflects – and reinforces – spatial inequalities and makes redistribution and equality of access to services more difficult across a metro area. The implications for Inclusive Growth are notable as spatial impediments to the prosperity of particular groups tend to result in poorer performance for metros as a whole.
- **Urban planning.** Urban planning procedures can reinforce intra-urban inequalities, particularly where, as is often the case, housing supply is constrained (and housing prices thus elevated) by an inflexible planning system. Strikingly, successful and growing cities are often those with the most restrictive policies, which makes it particularly hard for lower-income people to benefit from their prosperity. Indeed, many urban growth-control policies are designed to limit the influx of low-income people to an area (e.g. those that impose low-density requirements, require minimum housing size, or ban attached homes). More generally, the technical nature of much urban planning, coupled with the fact that it is often conducted with minimal publicity, tends to favour the interests of better informed, better resourced communities and sectoral interests.

The two issues are, of course, interlinked, since metropolitan fragmentation often enables local authorities to pursue planning and urban development policies that are inconsistent with the goals of both inclusion and growth for the larger urban economy. Lack of co-ordination of transport, housing and land-use policies, in particular, can be particularly detrimental to social, economic and environmental outcomes.

Sources: Kamal-Chaoui, L. and J. Sanchez-Reaza (2012), “Urban Trends and Policies in OECD Countries”, *OECD Regional Development Working Papers*, No. 2012/01, OECD Publishing; OECD (2012a), *Redefining “Urban”: A New Way of Measuring Metropolitan Areas*, OECD Publishing; OECD (2012), *OECD Territorial Reviews: The Chicago Tri-State Metropolitan Area*, OECD Publishing; OECD (2011c), *OECD Regional Outlook 2011: Building Resilient Regions for Stronger Economies*, OECD Publishing; Cheshire, P. and S. Sheppard (2002), “Welfare Economics of Land Use Regulation”, *Journal of Urban Economics*, 52, pp. 242-69; Spink, P., P. Ward and R. Wilson (eds.) (2012), *Metropolitan Governance in the Federalist Americas: Strategies for Equitable and Integrated Development*, University of Notre Dame Press, South Bend.

Inclusive policy making: A sound process with the right tools

Key elements of an inclusive policy process

The way policies are designed and implemented matter for Inclusive Growth. A policy-making process that is inclusive builds upon reliable information, provides a structure to exchange it, and aligns incentives and expectations of different actors effectively. This facilitates an engagement process that achieves credible commitments and is conducive to citizens' trust in institutions and co-operation for implementation. This policy process has the following core characteristics:

- **The policy-making process is well-informed.** This depends, in part, on i) the inclusiveness of the information available to decision makers, to ensure that it covers the relevant stakeholders, with the classifications and breaks to reflect the different importance of the issues, and ii) the quality of the information available to decision makers, associated with mechanisms such as evaluation, and performance management.
- **The policy-making process reflects the public interest.** The policy-making process should safeguard the public interest and avoid capture, while effectively aggregating what may be competing, but legitimate, interests. The recognition and effective regulation of formal mechanisms to influence policy making, including lobbying or support to political parties can help strike the right institutional balance.
- **The policy-making process is aligned with broader principles and high standards of governance.** Studies show that a crucial determinant of trust in government is whether government can be expected to take the right decisions and safeguard the public interest without the need for scrutiny. Integrity tools and mechanisms, embedded within a solid integrity framework to prevent corruption and foster high standards of behaviour, are necessary to reinforce the credibility and legitimacy of the actors involved in policy making.

These characteristics correspond to policy levers that governments can use to support a more inclusive policy process. For example, citizen engagement, access to information and open government can be leveraged to render the policy-making process more informed. Effective management of conflict of interest, good standards of behaviour in the public sector, and adequate lobbying and political finance regulation, can be leveraged to limit undue influence and build safeguards to protect the public interest (Table 5.1).

Mechanisms that support inclusive policy making. Inclusive policy making employs a variety of mechanisms, each targeting specific aspects of inclusiveness. Some mechanisms may aim to legitimatise public decisions, others advance evidence-based decision making (rationality), and yet others aim to raise support for policy actions among different stakeholders (integration). Participatory bodies advance legitimacy by allowing participation and political representation of different groups in the policy-making process. Policy making supported by independent consultation bodies and technical capacity can also enhance legitimacy by supporting problem definition and possible solutions based on evidence, helping policy makers to distinguish between facts and opinions. Finally, structured dialogue with stakeholders is crucial to develop feasible and sustainable policy solutions. The remainder of this section examines each of these mechanisms.

Table 5.1. Policy levers for building trust in the policy-making process

Key characteristics	Guiding elements	Policy levers	
The policy-making process is well-informed	Inclusiveness of the information and views relevant to the specific policy problem available to decision makers. Quality and reliability of the information available.	Access to information Citizen engagement Open Government Supreme Audit Institutions <i>Ex ante</i> and <i>ex post</i> evaluation Performance budgeting Regulatory impact assessment	Transparency, Reliability, Openness
The policy-making process is aligned with the public interest	Ability of the policy-making process to safeguard the public interest and avoid capture, while effectively aggregating competing, but often legitimate interests.	Transparency and integrity in lobbying Political finance regulation	Safeguarding Integrity and Curbing Undue Influence
The policy-making process is aligned with broader principles and high standards of governance.	Integrity framework, aimed at preventing corruption and fostering high standards of behaviour, thus reinforcing good policy making.	Conflict of interest management Codes of Conduct Transparency of the policy-making process	

Source: OECD (2013g), *Investing in Trust: Leveraging Institutions for Inclusive Policy Making*, paper presented to the 47th OECD Public Governance Committee.

Participatory bodies as enablers for inclusive policies. Participatory bodies have an important role to play in inclusive policy making. Each of the objectives for inclusive policy making may be pursued through different types of participatory bodies. Legitimacy can be advanced by expert groups, such as in the case of truth commissions, like in Chile and South Africa. Evidence-based decision making can be served by inter-ministerial commissions that aim at discussing the experiences and opinions of different entities of the public administration. Integration can be the objective of technical parliamentary commissions that aim at including different stakeholders through audiences, for example.

To fulfil their mandate, participatory bodies need to have certain characteristics. Legitimacy requires autonomy from the government, membership from outside the administration, and timely delivery of results, so that consultation is not used as a delaying strategy. A clear mandate and access to relevant information are necessary to advance evidence-based decision making. Integration is achieved by plurality, allowing opinions beyond those of the members of the consultation body, and by acting transparently, providing justifications for each proposal (Marcel, 2009). The 2006 Presidential Advisory Council on Pension Reform in Chile provides an example of how a participatory body helped to move reform forward in a controversial field (Box 5.2). Another example is the processes put in place by Malaysia in 2007 to secure engagement and support through PEMUDAH, a special taskforce to oversee regulatory reforms to facilitate businesses (Box 5.3).

Participatory bodies can exist at all levels of government. For example, sub-national citizen councils can act to steer and promote regulatory reform. These have been used by several of Mexico's federal states (Box 5.4). Experiences in Mexico suggest that such councils should be legally established with a clear mandate, be led by citizens, have top-level political support, be multi-disciplinary and have representative membership, act in a consultative role to government, meet periodically, possess a well-defined structure, with working groups to address specific topics and have an autonomous administration (including its budget) (OECD, 2012d).

Box 5.2. The experience of the Presidential Advisory Council on Pension Reform in Chile

President Bachelet made two major commitments after taking over the presidency of Chile in 2006: participative government (*gobierno ciudadano*) and pension reform. Until then, the experience of Chile concerning participative mechanisms for designing, executing, and evaluating public policies was quite limited.

President Bachelet established the Presidential Advisory Council on Pension Reform (*Consejo Asesor Presidencial para la Reforma Provisional*, CAPRP) in March 2006, just one week after the inauguration of her term. The CAPRP's mandate was to develop reform proposals for the pension system taking into account opinions by the general public and stakeholders linked to the pension sector. The CAPRP brought together 15 experts with different political and professional profiles, designed a programme of work, which included an intense stage of audiences, commissioned polls and opinion studies, and produced a set of proposals after 100 days of work.

The members of CAPRP included engineers, lawyers, sociologists, and a civil engineer; eight coming from the academic sector or NGOs, six from the private sector, and one from an international organisation. Almost half had some previous experience in the public sector. Significant representation from outside the government coalition was actively pursued. However, membership avoided corporate representatives of a specific sector or advocates of a particular reform in order to advance an open dialogue.

The first month of work was spent holding audiences. Forty-nine audiences were organised for 73 organisations and 242 individuals. Forty percent of the audiences were granted to trade unions and social organisations, 27% to employers and stakeholders from the financial sector, and 33% for experts, academics, and international organisations. Audiences were organised at the initiative of the CAPRP or by request of interested parties. Participants were to submit a 15 page position document previous to the audience and a one page synthesis of their presentations to be shared with the press and uploaded in the CAPRP website.

The CAPRP report provided the foundations for the reform bill that the President introduced in Congress and that became law in January 2008. The final report consisted on three volumes: diagnosis and proposals (81 of them), documents from consultations, and an executive summary. Among other features, the success of the CAPRP is attributed to 1) a clear mandate, with access to critical information, and a well-defined scope of the work to be undertaken; 2) autonomy from the government and a clear timeline; and 3) plural membership and transparency in the process of consultation.

Source: Marcel, M. (2009), "Nuevas modalidades participativas en la formulación de políticas públicas en Chile: La experiencia del Consejo Asesor Presidencial para la Reforma Previsional", Inter-American Development Bank, multicop.

Box 5.3. Partnership in improving the regulatory environment of Malaysia

The Special Taskforce to Facilitate Business (PEMUDAH) was established in February 2007 to oversee regulatory reforms to facilitate business in Malaysia. PEMUDAH reports directly to the Prime Minister and is composed of high-level business representatives and secretary generals of key ministries. It is co-chaired by the Chief Cabinet Secretary and a prominent captain of industry.

The work of PEMUDAH has included a systematic review of all business licenses, legislations and regulation. As of October 2013, 803 licenses were simplified and composited into 466, nine licenses were abolished, and 19 are in the process of being eliminated – representing a total cost savings to business of RM729 million per year (EUR 160 million). PEMUDAH also introduced the requirement for online public engagement by all ministries and agencies for all new proposals or amendments to by-laws, policies, regulations, etc. This is designed to improve the inclusiveness of government policy making. The Taskforce has also contributed to policy improvements in a variety of areas including the autonomous liberalisation of over 40 sectors, allowing up to 100% foreign equity participation in selected sub-sectors, and introduction of new immigration policies (i.e. permitting a resident pass for up to 10 years, abolishing time limits on the approval of employment passes, and automatic issue of expatriate passes and work permits for expatriates' spouses). The trust that has been built between the private and public sector through this body has enabled the number of reforms to date and potential new reforms are also in progress.

Source: OECD (2013f), *Malaysia Good Regulatory Practices*, Interim Report (unpublished).

Box 5.4. Citizen councils to promote regulatory quality at the sub-national level in Mexico

Several Mexican states have created councils and committees to promote improvements and continuity of reforms in regulatory management at the local level. In most cases, businesses and other stakeholders from private entities are represented and take part in the decision making process. Some examples are the following:

- The Economic and Social Council of Mexico City was established by law in 2009 to support the Government of Mexico City in areas of sustainable development, fostering economic growth and job creation, and better income distribution to reduce social gaps in Mexico City. The Council is a representative, economic and social participation body, with a consultative character that can make recommendations to the Government of Mexico City. The Council is composed by Government officials, seven business representatives, seven individuals from academia, seven representatives from civil society, seven from trade unions, and four individuals from professionals associations.
- In the State of Colima, the 2011 State Law of Regulatory Improvement established a State Council for Regulatory Improvement, which incorporates representatives from business, academia, and civil society associations. The contributions of the Council include analysing and reviewing all valid regulations in the state's jurisdiction to make recommendations for improvement; helping elaborate and update the Registry of Formalities and Services; participating, in co-ordination with social and productive sectors, in the design of draft regulations that impact the activities of businesses and citizens; proposing regulatory improvements at municipal level; strengthening Municipal Business Centres or one-stop shops to promote economic activity; and publishing opinions on regulatory impact analyses.
- In Nuevo Leon, the Citizen's Council for Regulatory Improvement is one of the leading institutional arrangements for regulatory policy in the state. Created by law, it includes representation from business, civil society, and academia. Among other functions, the Council issues opinions about the State Regulatory Improvement Programme, participates in the review of state-level regulation, promotes co-ordination between public, social and private sectors on issues pertaining to regulatory improvement, and promotes regulatory reform at municipal level.
- The Law for Regulatory Reform in the State and Municipalities of Jalisco established the Committee for Regulatory Reform (COMERJAL), which is composed by representatives of the federal government (15 members), the State of Jalisco Executive branch (17 members, plus the President, Vice-president, and Technical Secretariat of the committee), the State Legislature, the State's Judicial branch, municipalities (16 members), business groups (16 members), and the social sector (6 members). The social sector is represented by the Workers Confederation (CTM), the Workers and Peasants Revolutionary Federation of Jalisco, the Regional Workers Confederation, the Peasants National Confederation (CNC), the Federation of Neighbourhood Associations of Jalisco, and the Agrarian Communities League. COMERJAL is one of the most diverse citizen councils found in Mexico.

Source: OECD (2012), "Guía para mejorar la calidad regulatoria de trámites estatales y municipales e impulsar la competitividad de México" (Guide for improving state and municipal regulatory quality and promoting competitiveness in Mexico), OECD Publishing.

The proximity of local authorities to the citizens they serve creates an opportunity to draw them into the policy process. The City of Copenhagen, Denmark, for example, has a long tradition of citizen engagement and, in the late 2000s, involved citizens in the formulation of the Regional Development Plan for the Capital Region (OECD, 2009c). Yet participatory decision-making can be even more important in less cohesive places, where the urban space is highly contested and characterised by relatively volatile and fragmented alliances. In such cases, building alliances for a more competitive and inclusive processes for decision-making becomes imperative. That is perhaps why South Africa introduced requirements for citizen participation in its legislation and why the authorities in cities like Cape Town and Gauteng have worked hard to invest those processes with meaning

and to ensure that they do not become formal exercises, which is often a real risk (OECD, 2008, 2011e). Contested environments are not limited to middle-income countries: in Toronto (Canada) a contested municipal merger led to deep political divisions that persist to this day. Yet the city council managed to adopt a new economic development strategy unanimously in January 2008, after the city shifted from a consultation model to a co-production model: instead of drafting a strategy for consultation and comment, the city administration invited civil society actors to participate in the elaboration of the strategy from the beginning (OECD, 2010c).

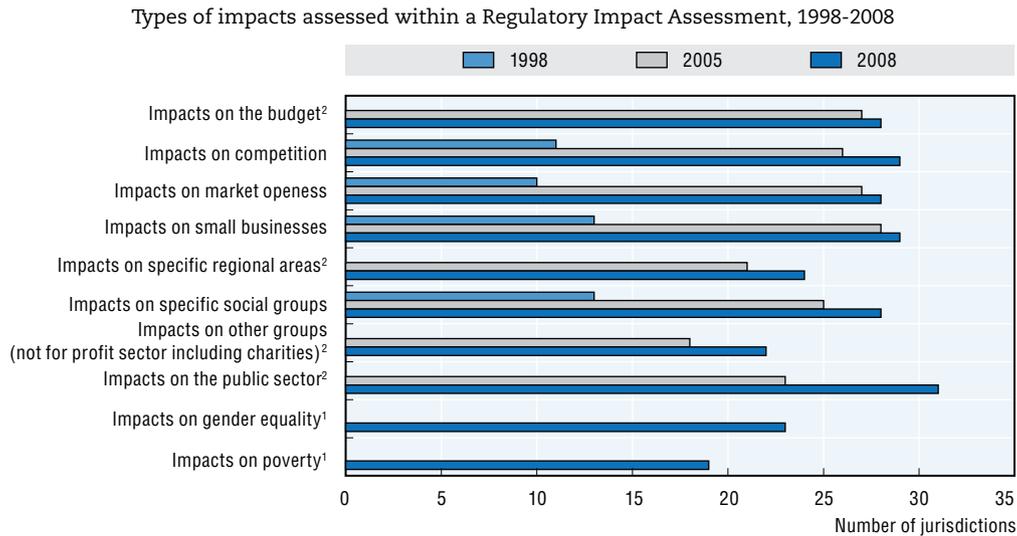
Tools for evidence-based policy making. Governments can use a variety of instruments to strengthen the evidence base for decision making. These tools clarify the effects and the trade-offs of government actions for decision makers and stakeholders alike. They include, but are not limited to, regulatory impact assessment, investigatory commissions, cost-benefit analysis, *ex-post* evaluation and performance-based budgeting. If used systematically these tools provide strong levers for governments to promote both inclusive political processes and to ensure that issues of social inclusiveness are mainstreamed in rule-making and policy choices.

At its core, evidence-based policy making incorporates consistent use of data to inform policy decisions. This approach to policy making involves i) generating and gathering basic data; ii) transforming data into actionable evidence; iii) using evidence in key decision-making processes, and iv) disseminating evidence and involving stakeholders to sustain reform implementation (OECD, 2012f). Each of these steps requires further synthesising information in a way that can respond to the interests and capabilities of different stakeholders.

Ex ante and *ex post* regulatory impact assessments play a role in revealing and monitoring the trades-off between economic, social and environmental effects of potential regulatory responses. A well-functioning regulatory impact analysis (RIA) system can assist in promoting policy coherence by making transparent the trade-offs inherent in regulatory proposals, identifying who is likely to benefit from the distribution of impacts from regulation, and how risk reduction in one area may create risks for another area of government policy. Indeed, the range of impacts that are routinely required to be assessed within a RIA has evolved significantly over the last decade to include competition, market openness, budget and the public sector, specific social groups and small businesses. The inclusion of social concerns has also become more widespread: an assessment of the impact on poverty is required in more than half of OECD countries (Figure 5.4). Canada provides a concrete example of how RIA can be used to give special consideration to vulnerable social and economic groups (Box 5.5).

Many emerging and developing economies have begun applying regulatory impact assessments to systematically enhance rule making and improve the business environment. In Latin America, for instance, Brazil has established its PRO-REG programme in the President's Office to implement RIA. In Southeast Asia, Malaysia, Viet Nam, Cambodia and Laos are all in the process of piloting or introducing impact assessments. In Africa, South Africa, Uganda, Tanzania and Zambia have also introduced impact assessments. In these countries the requirements for analysis have been adapted to suit the country priorities and national strategies, whether that is encouraging small businesses, improving economic productivity or poverty reduction.

Figure 5.4. **The types of impact assessments have significantly increased in OECD countries**



Notes: Jurisdictions involve OECD countries and the European Union. For 1998 no data are available for the European Union, Luxembourg, Poland, and the Slovak Republic. This means that this figure is based on data for 27 countries in 1998 and for 30 countries and the EU in 2005/2008.

1. No data are available prior to 2008.

2. No data are available prior to 2005.

Source: OECD (2009), "Indicators of Regulatory Management Systems", www.oecd.org/regreform/indicators. Data for Brazil, Russia and South Africa are available on www.oecd.org/gov/regulatory-policy/rmscountrynotes.htm.

Box 5.5. Inclusive rule making procedures in Canada

Including different communities: In Canada, the Cabinet Directive on Regulatory Management explicitly states that "departments and agencies are also to work with First Nations, Inuit, and Métis communities and peoples; with national, regional, and local aboriginal organisations; and with aboriginal governments" when consulting on draft regulatory proposals. In fact, when assessing regulatory impacts on society and culture, the Triage Statement Form (which determines whether a new regulatory proposal is subject to a low impact or to a medium/high impact RIA) advises government ministries and departments to give special consideration to vulnerable social and economic groups, such as aboriginal peoples, official-language minorities, lower income Canadians, recent immigrants, and groups affected on the basis of age, gender, race, and culture.

Including small business: Canada's regulatory policy now also includes the requirement to adopt a "small business lens" when assessing regulatory proposals. The objective of the small business lens is to reduce regulatory costs on small businesses without compromising the health, safety, security, and environment of Canadians. The small business lens ensures that regulators are sensitive to the needs of small businesses when they design regulations. The lens introduces a number of new requirements that regulators must consider when designing regulations that will impact small business. Regulators must complete a checklist that guides consultation with small business to understand their realities at the earliest stages of design. They will have to demonstrate to ministers that due consideration was given to reduce the burden associated with the option imposed upon small business. If a less burdensome option is not adopted, regulators will have to justify why.

Source: Treasury Board Secretariat of Canada (2014), "Red Tape Reduction Action Plan", webpage, www.tbs-sct.gc.ca/rtrap-parfa/index-eng.asp, consulted on 23 January 2014.

As noted previously, special commissions can play a role in evidence-based decision making. Among the tools adopted by countries to better integrate regulatory policy and Inclusive Growth, several countries have established special commissions to provide advice on how regulatory reforms for productivity impact inclusiveness objectives. For instance, the *Productivity Commission of New Zealand* advises the Government on improving productivity in a way that is directed to supporting the overall well-being of New Zealanders. The Commission undertakes in-depth inquiries on topics referred to it by the Government, carries out productivity-related research that assists improvement in productivity over time, and promotes understanding of productivity issues.

Performance-related budgeting tools also allow for greater transparency of the objectives and results of public policies. These tools contribute to justifying public programmes in terms of performance and impact on the lives of citizens.⁵ Performance-related budgeting tools should be coupled with robust evaluation processes to assess how well targets are being met. It is important that these processes have a strong public-facing aspect, not just in the interests of transparency *per se*, but also to lend these processes greater legitimacy and force as tools of accountability.

Finally, tools that reveal the gender-specific impacts of policies and programmes contribute to inclusive policy making in various domains. For example, introduction of gender mainstreaming and gender impact assessments have led to improvement in care provisions and leave arrangements, as well as actions to desegregate labour markets across EU member states. This in turn strengthens equality of access to labour market opportunities of both men and women (Rubery, 2002). Indeed OECD countries (e.g. Austria) are increasingly adopting the use of gender impact assessments or gender-sensitive budgeting to assess gender implications and ensure gender-sensitivity and responsiveness of government actions. These practices however are not yet fully integrated into the mainstream policy analysis and budgetary process (OECD, 2014b). Some developing countries, such as the Philippines, Peru, and Thailand are also engaging in some form of gender mainstreaming and gender-responsive budgeting.

Public consultation to support public interest, trust and legal certainty. Public consultation of regulation plays an important and multi-faceted role in inclusive policy making. These consultations contribute to improving the quality of regulation and the governments' responsiveness to citizens and firms. They also support evidence-based decision making in government, educate stakeholders, improve regulatory compliance, promote trust in government, and bolster the legal security of citizens and businesses (OECD, 2011d). Transparency and participation in the regulatory process is an important pre-requisite to ensure that regulation serves the public interest and is informed by the legitimate needs of those interested in, and affected by, regulation.

Evidence from OECD countries highlights critical conditions for effective consultation, communication and stakeholder engagement. A clear, enforceable, measurable, government-wide policy on active stakeholder engagement in developing and reviewing regulations is crucial (OECD, 2013c). Such a policy needs to be accompanied by mandatory but flexible guidelines for stakeholder engagement. Public consultation implies inviting the general public to comment on draft regulatory proposals, providing sufficient time for submitting comments, and offering clear indications of how comments can be submitted. Information and communication technologies can be used to broaden outreach efforts and facilitate consultation (Box 5.6). ICT tools must be user-friendly, capitalise on users' existing social networks, and use plain language in communication (OECD, 2010e).

Box 5.6. *Regulations.gov* in the United States

Regulations.gov is the one-stop, online source for the public to search, view, and comment on regulations issued by the US government. On average, US federal agencies and departments issue nearly 8 000 regulations per year. In the past, if members of the public were interested in commenting on a regulation, they would have to know the sponsoring agency, when it would be published, review it in a reading room, then struggle through a comment process specific to each agency. Today using *regulations.gov*, the public has the potential to shape rules and regulations that impact their lives, from anywhere.

The e-Rulemaking Program is working to meet users' needs by enhancing *regulations.gov*. In July 2009, *regulations.gov* was re-launched with enhanced search functions, and several communication and information sharing features. Since this re-launch, site updates are continually made with the goal of further engaging the public and enhancing their participation in the regulatory process.

Citizens share their opinions on what features and functions they would like to see on *regulations.gov* through online surveys, focus groups, usability testing, and comments received on *Regulations.gov Exchange* – an online forum launched in May 2009 to solicit public feedback. The *Regulations.gov Exchange* forum was re-launched in January 2010 to continue to provide users with two-way communication, particularly as the e-Rulemaking program works to update and improve the *regulations.gov* website.

Source: Excerpted from *www.regulations.gov* consulted on 28/01/2014.

Since stakeholder engagement can be costly and subject to “review fatigue”, it needs to be well-targeted and efficient. This can be achieved by good planning and by ensuring that resources dedicated to consultation and the depth of the process are proportional to the impact of the regulation. Consultation should be undertaken early in the process, before legislation is drafted, ideally when the problem is defined and the goals for a government intervention are set. The earlier in the stakeholders are taken on board, the less likely it is that there will be demands for substantive changes when the final draft is ready. Engaging stakeholders throughout the process of developing regulations also increases a sense of ownership and compliance. In addition to consulting when developing new regulations, it is equally important to involve stakeholders when reviewing existing regulatory stock to take into account the users' perspective (Box 5.7). Sufficient resources must therefore be available for this process.

Ensuring that consultation practices are effective requires establishing a monitoring and review system, including a set of evaluation indicators. It is important to ensure that stakeholders' views are actually used to inform decision-making, and not just to justify a decision already taken. Demonstrating the value of consultation by gathering evidence on its impact can also help minimise political resistance to engagement. Countries can use qualitative methods and indicators to evaluate and improve the quality of the review process. Capacity building for consultations and engagement across the government needs to take place and a network enabling the sharing of good practices across the government should be established.

Finally, simply granting access to public consultations may not lead to an inclusive policy process. In order to ensure inclusiveness, governments should lower the barriers (e.g. distance, time, language, access) for those who wish to participate. Governments should also build the capacity of citizens so that they can participate effectively and increase the appeal of consultation and participation initiatives (OECD, 2009d).

Box 5.7. **Australia's Quarantine and Biosecurity Review: A model consultation arrangement**

In February 2008, Australia launched a review of its quarantine and biosecurity systems. An independent panel of experts, appointed by the Minister for Agriculture, Fisheries and Forestry, was asked to review the appropriateness, effectiveness and efficiency of current arrangements, including public communication processes and governance and institutional arrangements. The Panel first prepared and released an issues paper in order to prompt discussion and attract submissions and comments from stakeholders. It received around 220 written submissions from a wide range of interested parties, including overseas submissions. The Panel organised over 170 meetings with domestic and international stakeholders, both individuals and representatives of organisations. It also sought information from Australia's trading partners on their arrangements for managing biosecurity risks; held discussions with government officials and business representatives in New Zealand, North America, Europe; and met with representatives from other WTO members. A dedicated website supported the process: reference documents used during the review were made available online, alongside copies of all the submissions received.

At the completion of the process, *One biosecurity: A Working Partnership* (also known as the Beale Report) was submitted to the Australian Government. It described the current situation, summarised the comments received, and presented recommendations. The Australian Government released its preliminary response to the report in December 2008, agreeing in principle with all 84 recommendations and outlining the corresponding actions the government intended to take. The response is publicly available online, along with updates on progress with reform.

Source: OECD (2010d), *OECD Reviews of Regulatory Reform: Australia 2010: Towards a Seamless National Economy*, OECD Publishing, Paris, p. 188, <http://dx.doi.org/10.1787/9789264067189-en>.

Inclusive implementation and evaluation: Partnering with citizens

Citizen participation is also important for policy implementation, evaluation and feedback. Different forms of active engagement can move governments beyond traditional consultation processes to more interactive and potentially inclusive forms of participation. There is increasing evidence that collaboration with citizens and service users can help tackle service failure, improve democratic governance, builds public trust, and drive innovation in the public sector.

Participatory budgeting: Strengthening role of citizens in allocation of the public purse

Participatory budgeting gives citizens a direct role in the allocation of public budgets. In doing so, it provides citizen taxpayers with a say in how public monies are spent on the services that affect them. Broadly speaking, five criteria need to be met: "1) the financial and/or budgetary dimension must be discussed; participatory budgeting involves dealing with the problem of limited resources; 2) the city level has to be involved, or a (decentralised) district with an elected body and some power over administration (the neighbourhood level is not enough); 3) it has to be a repeated process (one meeting or one referendum on financial issues does not constitute an example of participatory budgeting); 4) the process must include some form of public deliberation within the framework of specific meetings/forums (the opening of administrative meetings or classical representative instances to 'normal' citizens is not participatory budgeting); 5) some accountability on the output is required" (Sintomer et al., 2008, p. 168). In recent years, participatory budgeting has been implemented in a number of cities around the world (Box 5.8).

Box 5.8. Participatory budgeting in selected OECD municipalities

Toronto, Canada: Since 2001, the Toronto Community Housing Corporation (TCHC) has used a participatory budgeting process to involve tenants in budget decision making as part of their Tenant Participation System. Originally called Community Based Business Planning, the budgeting process has allowed tenants to decide how to spend USD 9 million per year, or 13% of the TCHC's capital budget. The TCHC is the largest social housing provider in Canada and second largest in North America, with 164 000 tenants housed in over 350 high and low-rise apartment buildings and 800 houses and duplexes. With an average income of USD 15 400, TCHC residents are generally low-income individuals and families. Many residents are new immigrants, elderly, disabled, or single parent families, which are some of the most marginalised populations in Toronto.

Morsang-sur-Orge, France: This municipality is a middle class suburban city with a population of around 19 500. In 1998 the administration created eight neighbourhood councils open to all residents. Elected representatives also participate in order to discuss proposals with the community but they do not have voting rights. Each council was allocated EUR 60 000 for local projects and they have full autonomy to decide how these resources are spent. Together the councils control 20% of the city's investment budget. In 2002 the municipality expanded popular participation by introducing five thematic workshops where residents and politicians meet to discuss projects for the municipal budget. The results are then presented to the municipal council.

Berlin-Lichtenberg, Germany: Berlin-Lichtenberg is a borough in Eastern Berlin with 251 000 residents. The borough consists of 13 districts. The participatory budgeting project allows citizens to discuss and express their preferences with regards to discretionary fields, including support of public health, business counselling, planning parks and free space, libraries, general support for children and adolescents, cultural services of public institutions, school of music, voluntary services by senior citizens, care of senior citizens, sports, care of street greenery, care of street trees, care of parks, care of playgrounds, and schools for continuing education. Each year, the borough allocates € 31 million to implement citizens' preferences and suggestions.

Seville, Spain: Inspired by the example of Porto Alegre in Brazil, participatory budgeting was introduced in Seville in 2004. The city of 700 000 people is divided into 21 assemblies, which were attended by around 9 000 people in 2006. The assemblies have their own constitution, known as 'autorreglamento', which was drafted by a commission of delegates elected by the assemblies. Each year the council decides the amount to be allocated by the assemblies, but at least 50 per cent of the city's budget for local districts is within their control. Currently, the city council's departments of public works, sport, youth, education, culture, environment, health and gender have opted to join. The assemblies choose delegates to monitor the execution of policies; they are accountable to the assemblies from which they were elected. Participatory budgeting has led to the construction of a network of cycle lanes across the city, as well as several swimming pools and sports grounds. Urban renewal programmes, such as the construction of new drains and pavements, have also been undertaken in poorer neighbourhoods and priorities agreed for repairing schools.

Source: OECD (2011e), *OECD Territorial Reviews: The Gauteng City-Region, South Africa 2011*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264122840-en>.

Co-production: Moving beyond consultation to stakeholder engagement in planning and delivery

Co-production is based on the premise that public services work better when designed and delivered in partnership with citizens. Co-production corresponds to the direct involvement of individual users and groups of citizens in the planning and delivery of public services. Partnering with users and citizens has emerged as an alternative route to traditional service delivery approaches (i.e. supply-side schemes and command and control models)

and as a result of trends already underway in OECD countries (i.e. client orientation, service personalisation). It represents a step forward from public consultation as it involves a more in-depth and systematic association of citizens and users who are not only consulted but also help to create the services. For example, governments co-produce with citizens when they release information which is then re-used by citizens to create or improve services (e.g. combing information on local bars and crime data to help people plan safer routes home), or when they partner with citizens or volunteer groups to monitor the physical conditions of public infrastructures and services or to increase safety in their neighbourhood.

Co-production can improve outcomes through community involvement and tackle service failures while promoting inclusiveness and participation. At a community level, co-production can lead to service improvements, for example when local residents and NGOs take over local amenities, such as parks and libraries that are under threat and reorganise them as multi-functional spaces for care assistance, capacity building and training, and local cultural events. Co-production schemes have also been used to involve society to identify solutions to problems which cannot be solved by government acting alone (e.g. climate change, water shortage) and that can lead to social exclusion (e.g. obesity and other chronic health conditions) (Box 5.9). At an individual level, co-production which builds on input from service clients can deliver positive results in tackling service failures and lead to reduced cost for the public purse. For example, in the area of juvenile justice, engaging young people as advocates of good behaviour can lead the way to young offenders' reinsertion in society. Peer-to-peer support schemes can be used in schools as a way to tackle achievement gaps, promote greater inclusiveness and participation.

Box 5.9. Improving water supply: The São Francisco Project (Brazil)

In Brazil, a partnership between governments, public entities, civil society and private sector organisations has been set up as a way to find solutions for the improvement of water supply in the North-East region of Brazil. The São Francisco Project is a national level initiative which aims to integrate São Francisco to watersheds in the north-east region of Brazil in order to supply potable water to 12 million people in the states of Pernambuco, Paraíba, Ceará and Rio Grande do Norte by 2025.

Civil society organisations are involved in social and environmental programmes which form part of the project. They co-decide on questions related to social aspects, such as the decision to relocate the affected families or participate in the monitoring of the welfare and satisfaction of citizens during and after the execution of the project. The rural population directly affected by the project initially showed resistance to changes however the co-production process made it possible to discuss and define their priorities.

As a result, citizens concerned by the project have access to health and education services, sanitation infrastructure and technical assistance to develop irrigated crops on their land. The affected families have their living conditions improved due to relocation. In native communities, actions are taken towards developing craftsmanship to raise the income of families. The effect of the project is a modification of labour structures in the region permitting the social and economic development of the communities involved.

Source: OECD (2011b), *Together for Better Public Services: Partnering with Citizens and Civil Society*, OECD Public Governance Reviews, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264118843-en>.

Enhancing citizens' role in evaluation

Evaluation is an important part of refining public policies. Participatory evaluation, which places stakeholders at the centre of assessing the success of policies and programmes, can improve the usefulness of evaluation results. Its advantage is that it raises the likelihood

that the outcomes of an evaluation will be accepted as relevant by all stakeholders and will provide the leverage needed to ensure that outcomes are used as a basis for future actions (a common shortcoming of independent evaluations). Furthermore, public participation is a cost-effective way to access empirical information on the relevance, effectiveness, efficiency, impact, and sustainability of public policies. Most OECD countries are still at the early stages of this type of public engagement. Embedding this type of approach requires a substantial investment in building capacity of participants and provision of methodological support (OECD, 2009b).

Citizens' contributions to evaluation can extend to legislation as well. Those most able to make a case for particular policies often have the greatest influence (i.e. powerful lobby groups). Hence, mechanisms can be put in place to help those with less access and influence make their case. Legislatures and specific committees often have a mandate to collect evidence (both written and oral) from experts, pressure groups and citizens directly affected by legislation. In addition to hearings, interviews and focus groups, legislatures may commission case studies of different regions, social or economic groups within society to gain a detailed perspective. They may also use polling data to tap into views from a cross-section of the public. In 2009, for example, the UK Better Regulation Executive commissioned a survey of the general public and the business sector to ascertain their views on the effects of regulation (OECD, 2012c). *Ex post* legislative evaluation can also be used to understand the ways in which the public has been affected by a law and identify ways in which citizens may want to amend it.

5.2. Pursuing a comprehensive approach to building inclusive institutions

Co-ordination across government departments and across levels of government

Given the multi-faceted character of Inclusive Growth, effective administration and co-ordinated action across multiple policy domains and levels of government are crucial. Identification of policy complementarities may make it possible to generate better outcomes in terms of combining growth and inclusion. Improved co-ordination at the policy level may also help to resolve the political economy challenges associated with Inclusive Growth. Bundling reforms together in cross-sectoral packages may make it easier to reach agreement on reforms, as the costs and benefits of policy initiatives can be more widely distributed, and those threatened by one measure may benefit from another (Tompson, 2009; Olofsgård, 2003).

The OECD has long stressed the need for such co-ordination, emphasising “whole-of-government” approaches or “joined-up government”. Not least, it is essential that strong links are established between national, government-wide strategic planning processes, which are usually multi-year in character and driven by the centre of government, and the annual budgeting and resource-allocation processes, which are driven by the central budget authority. Tools such as medium-term expenditure frameworks, performance-related budgeting and periodic reviews of expenditure allow for these correspondences to be clarified and reinforced.

In practice, implementing a whole-of-government approach is difficult and many policies continue to be made in sectoral “silos”. While achieving a government-wide approach involves many challenges that need to be addressed (e.g. co-ordination costs, political turf battles, lack of incentives to collaborate, insufficient resources for collaborative

working, budgetary implications of horizontal and vertical co-ordination), two key challenges tend to stand out:

- To identify and implement mechanisms, such as for cross-sectoral or inter-governmental consultations, which ensure that co-ordination takes place. Such mechanisms facilitate policy coherence and, wherever possible, help to realise potential complementarities among different strands of policy.
- Identify the policy interactions that matter most in terms of the “knock-on effects” of one policy on others. The distributional consequences of environmental policies, for example, need to be considered and addressed in parallel with environmental policy reforms, not afterwards. Similarly, changes in tax and benefit systems are too often undertaken in isolation to achieve specific ends. These objectives need to be considered in the context of the entire system of taxes and benefits that shapes individual incentives and distributive outcomes, confronting individuals with abrupt changes in, e.g. marginal tax rates, or producing outcomes where individuals with very similar characteristics are treated very differently.

There are a number of dimensions of cross-governmental co-ordination that matter:

- The first is horizontal, across policy sectors: at both national and sub-national levels there is often a tendency for public bureaucracies to work in silos, with too little co-ordination of, for example, environmental and transport policies, or between social protection and labour-market policies. Here, the solutions often depend on or benefit greatly from leadership at the central government level, including the implementation of mechanisms or the creation of institutions that ensure cross-sectoral discussion of cross-cutting policy challenges.
- The second concerns horizontal co-ordination across jurisdictions at sub-national levels of government. Here, the evidence increasingly points to the need for leadership from above (OECD, 2013d, 2014); even where state or local governments see the need to co-operate, the barriers to collective action can be hard to overcome without the resources and leadership that a higher level of government can provide. Both institutional and financial incentives may be required. The point is not that such collaboration can be imposed top-down but that a balance of top-down and bottom-up initiative is required.
- The third form is vertical co-ordination across levels of government; an important challenge, as almost all domestic policy fields are, at least to some degree, areas of shared responsibility in OECD countries. Multiple levels of government often have a role to play in designing, financing, and/or implementing policies with implications for Inclusive Growth. This points to the need for co-ordinating mechanisms that reflect the legitimate functions and democratic accountability of the various levels involved (OECD, 2013d). The recently adopted OECD Principles for the Effective Governance of Public Investment, for example, reflect this concern.

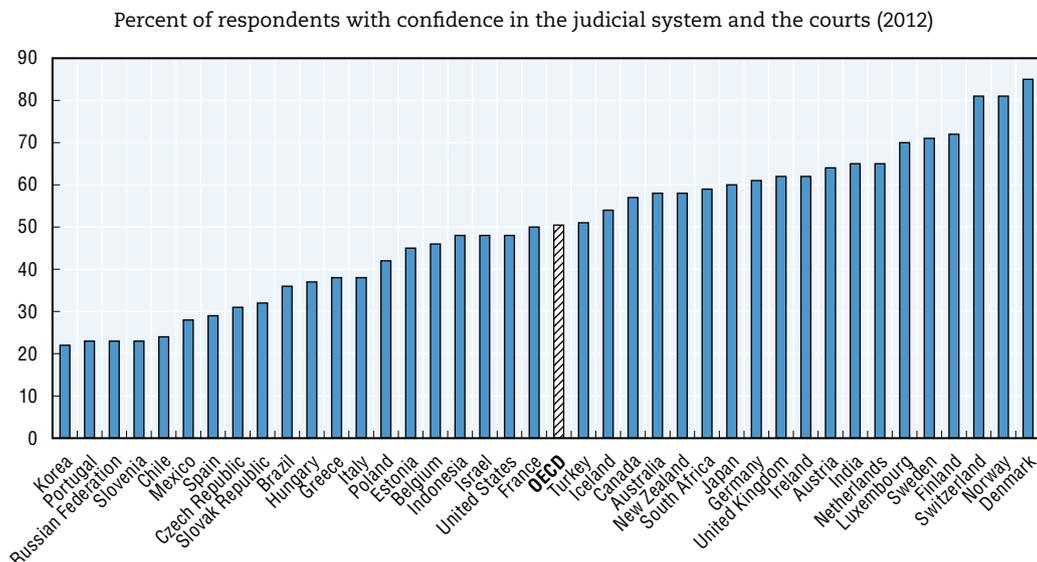
Checks and balances throughout government

A comprehensive approach to inclusive policy making requires checks and balances to be present throughout government. Strengthening justice sector performance, ensuring fiscal performance, and preventing regulatory capture are three such examples.

Improving justice sector performance

Rule of law, access to justice and redress are at the core of a fair and socially just society. The effective implementation of the law helps prevent conflict, crime and violence, ensures executive accountability, and fosters private sector growth in compliance with outlined regulatory frameworks. A legitimate and equally accessible judicial system helps to create a level playing field where predictable and independent decisions can be taken. Furthermore, ensuring equal access to justice can support equity in services, including health care and education, and thus contribute to reducing inequality. Yet not all citizens in OECD and BRIC countries are confident the justice system works as it should. Among OECD countries, confidence in the judiciary and the courts is highest in Nordic countries and lowest in Korea, Portugal, and Slovenia (Figure 5.5).

Figure 5.5. **Significant differences exist in levels of confidence in the judiciary across OECD countries**



Note: Confidence in the judicial system data refer to percentage of “yes” answers to the question: “In this country, do you have confidence in each of the following, or not? How about judicial system and courts?” Data for Chile, Germany and the United Kingdom are for 2011 rather than 2012.

Source: OECD calculations based on the 2012 Gallup World Poll.

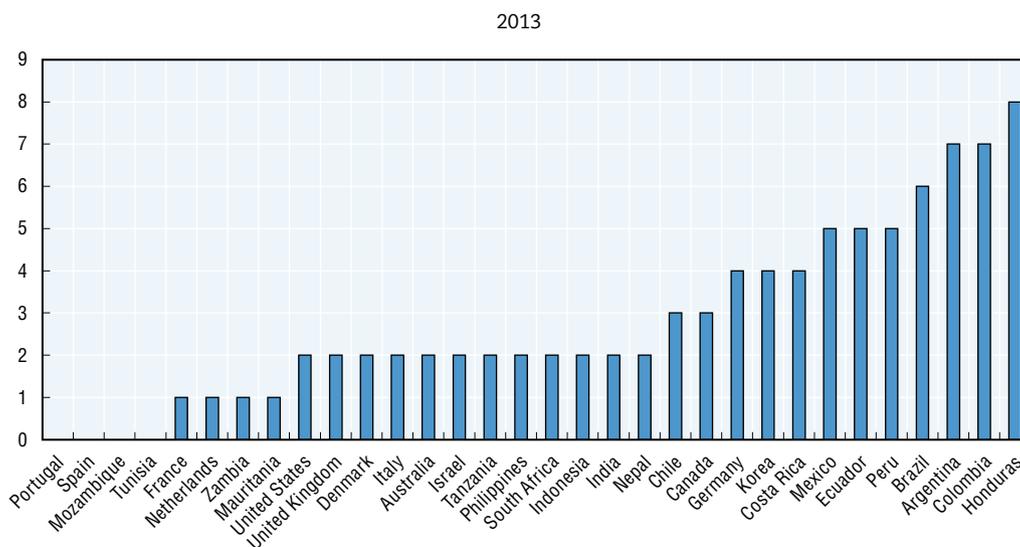
Strengthening effectiveness of oversight institutions

The national legislature has a fundamental role in authorising annual budget allocations and in exercising accountability for how these allocations are used. Indeed, the tools available to parliaments to assist them in this task have improved considerably in recent years. Most notably, several national parliaments (e.g. Australia, Canada) have developed parliamentary budget offices designed to address the “asymmetry of information” between the executive branch of government and the legislature on budgetary and fiscal affairs, and to strengthen the role of the legislature in identifying and representing the interests of citizens. Other countries, including Slovenia and Sweden, have established “fiscal councils” or similar bodies to provide an independent, professional perspective on complex issues of fiscal policy management, including assessing compliance with fiscal targets and identifying fiscal sustainability risks. Taken together, these “independent

fiscal institutions” can enhance the quality of public discourse and open the way for a more inclusive debate on fiscal policy choices and challenges. The OECD has developed draft *Principles for Independent Fiscal Institutions*, which set out how such bodies can best be instituted to promote these objectives.

Efforts to improve public sector performance and strengthen citizens’ participation can extend to the activities of autonomous bodies. Innovative approaches in developing countries and emerging market economies involve citizens in social audits (Philippines), complaint mechanisms, and taking part in the selection of the Auditor General (Ecuador and Colombia) (Figure 5.6). Many Supreme Audit Institutions (SAIs) have started involving citizens in their work, although many of these engagement practices have tended towards the one-way dissemination of information. Overall, it is important that accountability bodies develop risk mitigation strategies when engaging citizens in their work in order to ensure their involvement is sustainable and fits within the current political and enabling environment (OECD, 2015a).

Figure 5.6. **The range of participatory practices employed by Supreme Audit Institutions varies across countries**



Note: The indicator measures the number of distinct practices that have been implemented as of Dec. 2013, not the number, or frequency, of instances. A practice is counted just as long as it has been applied (tools exist/has been put into practice) after its creation and it has not been discontinued. Practices are counted regardless of whether or not they were instantiated in 2013.

Source: OECD (2015a, forthcoming), “Citizen Engagement and Supreme Audit Institutions: A Stocktake”.

Protecting regulators against capture

Regulatory capture by industry or government can undermine policy making for Inclusive Growth. Regulators are increasingly responsible for the delivery of a variety of policy objectives that can be conflicting or difficult to manage, such as environmental protection while encouraging investments or ensuring reliability and security of services, and minimising the costs to citizens and operators. In addition, as more regulators become independent from central government, their funding increasingly comes from elsewhere including from industry. In such a climate, there can be political pressures to influence regulatory actions and decisions by the regulators. Regulators with conflicting objectives can manage the delivery of those objectives to the extent that they have correct institutional

systems and mechanisms of accountability, transparency, engagement and leadership that protect regulatory decisions and actions from undue influence and ensure trust in the regulator. The *OECD Best Practice Principles for the Governance of Regulators* identifies the seven principles that combine to protect regulators from capture and also promote accountability (Box 5.10).

Box 5.10. OECD Best Practice Principles for the Governance of Regulators

1. *Role clarity*: For a regulator to understand and fulfil its role effectively it is essential that its objectives and functions are clearly specified in the establishing legislation. The regulator should not be assigned objectives that are conflicting or be provided with a resolution mechanism in case of conflict.
2. *Preventing undue influence and maintaining trust*: Independence from the government and from the industry that is regulated can improve the regulatory outcomes by allowing the regulator to make decisions that are fair and impartial. Formally protecting the independence of a regulator is an important element of achieving independence, even though it is not sufficient since a strong culture of independence and appropriate working relationships with the government and other stakeholders must also be in place.
3. *Decision-making and governing body structure for independent regulators*: The governing body structure of the regulator (e.g. a single head or a board of directors) should be determined by the nature of the regulated activities and their motivation.
4. *Accountability and transparency*: A regulator operates in accordance with the powers conferred to it by the legislature. Accountability and transparency can therefore be considered as the other side of the coin of independence. Regulators should regularly report on the fulfilment of their objectives, including through meaningful performance indicators. Key operational policies and other guidance material, covering matters such as compliance, enforcement and decision review should be publicly available.
5. *Engagement*: Regulators should regularly and purposefully engage with regulated entities and other stakeholders to enhance public and stakeholder confidence in the regulator and to improve regulatory outcomes.
6. *Funding*: Funding levels should be adequate and funding processes should be transparent, efficient and simple.
7. *Performance evaluation*: The regulatory decisions, actions and interventions of the regulator should be evaluated with the help of performance indicators. This creates awareness and understanding of the impact of the regulator's own actions and helps to communicate and demonstrate to stakeholders the added value of the regulator.

Source: OECD (2014a), *The Governance of Regulators, OECD Best Practice Principles for Regulatory Policy*, OECD Publishing, Paris, <http://dx.doi.org/10.1787/9789264209015-en>; Thatcher, Mark (2005), "The Third Force? Independent Regulatory Agencies and Elected Politicians in Europe", *Governance*, 18(3), pp. 347-373, July; Gilardi, Fabrizio and Martino Maggetti (2010), "The independence of regulatory authorities" in David Levi-Faur (ed.), *Handbook on the politics of regulation*, Edward Elgar Publishing, Cheltenham, United Kingdom.

5.3. Building inclusive institutions

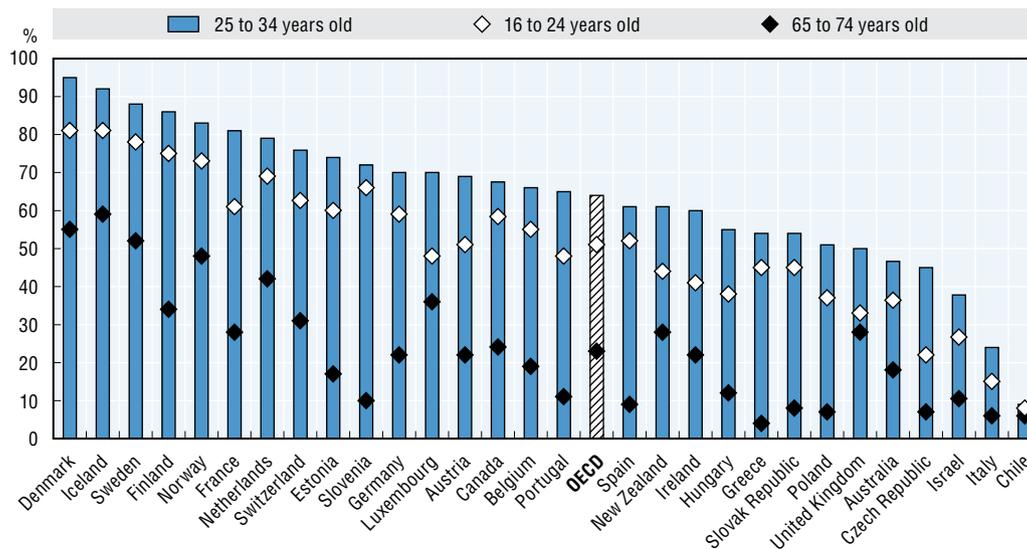
The contribution of technology to participatory governance

Information and communications technologies (ICTs) are enabling new forms of collaborative and participatory governance that act as a driver for Inclusive Growth. The steady integration of new technologies (e.g. social media, mobile technology) into the everyday lives of businesses, governments and citizens is giving rise to new forms of public engagement and relationships that overlap across public, private and social spheres in a new digital governance environment (Figure 5.7). The shift from a citizen-centric to a citizen-driven model of digital government is also opening up governments, driving a move from

“networked governance” (internal co-ordination and collaboration) to “collaborative and participatory governance” (more open forms to engage institutional and non-institutional stakeholders in public value creation).

Figure 5.7. The use of digital channels by the younger and older citizens to interact with the public sector remains below expected levels

Citizens' use of the Internet to interact with the public sector by age group, 2012



Note: Data unavailable for Japan, Korea, Mexico, Turkey and United States. Data for Australia, Canada, New Zealand, Israel and Switzerland refer only to obtaining information, not general interaction. In these countries the age group “25-34 years old” refers to individuals between 25 and 44 years of age. Data for Chile refer to the 25-64 years age group. Data for Israel cover citizens aged 20 and above and cover both obtaining information and filling in forms online. Data for Canada, Israel and Switzerland refer to 2010. Information on data for Israel: <http://dx.doi.org/10.1787/888932315602>.

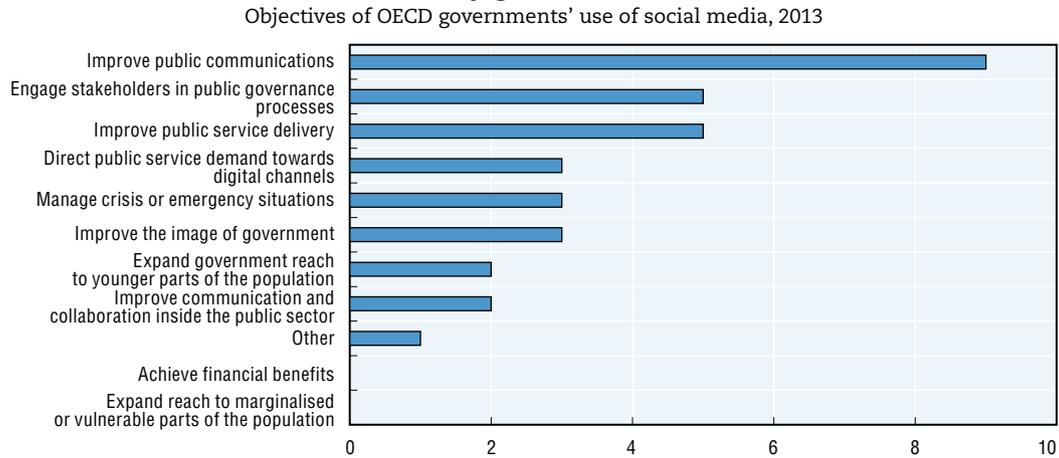
Source: OECD (2013b), *Government at a Glance 2013*, OECD Publishing, Paris, http://dx.doi.org/10.1787/gov_glance-2013-en.

In order to truly engage constituents, government institutions will have to devise ways of better using social media. Web 2.0 applications (i.e. Facebook, Twitter, YouTube, and Wikipedia), also called the participative web, have the potential to fundamentally alter the policy-making process. At present, however, government institutions perceive social media largely as a public communications tool. An OECD survey shows that out of eleven national governments that formulate explicit objectives for social media use, nine expect them to improve public communications (Figure 5.8 and OECD forthcoming). Similarly, a survey of US public authorities at different levels of government shows that 85% of those using social media do it to “distribute information”. Only a small percentage viewed social media differently: 31% indicated they use social media to have conversations [with constituents], 21% to receive feedback, 15% to inform about policies and only 9% to drive innovation (GovLoop, 2013). Along similar lines, a 2012 survey of local government authorities in the United Kingdom found that nearly all local councils use social media for external communications. Only around half aim to use social media for community building or to directly interact with the population, e.g. for handling enquiries (BDO, 2012).

Governments are thus faced with the opportunity and challenge of moving beyond the use of ICTs merely for distributing or collecting information. New technologies with open data can help governments actively engage with stakeholders. They have the potential to enable public participation and social engagement in designing responses to public needs

(e.g. co-development and co-production of services through newly developed apps) and to allow the sourcing information and knowledge from more diverse sources (e.g. crowd sourcing).⁶ New forms of collaboration with non-institutional stakeholders can help deliver services which better respond to specific needs and in more inclusive ways. Indeed, “Fix My Street” in the United Kingdom and Chicago’s “311” Internet portal illustrate the intersection of mobile government and open government data. One is built by citizens, the other by government (Ubaldi, 2013).

Figure 5.8. **Communication and engagement at the core of social media use by governments**



Note: Based on the response of 11 countries that indicated having specific objectives or expectations for government social media use; maximum three answer choices allowed.

Source: OECD survey on government use of social media, 2013 (preliminary results).

“Crowdsourcing” holds substantial potential for governments but is not necessarily easy to undertake successfully. Successful crowdsourcing depends on a sufficient scale and representativeness of participation to achieve valuable results.⁷ To date, only a limited number of national governments have embarked down this path and even fewer local and regional ones where the benefits are likely to be the greatest. US cities and the US Federal Government, the United Kingdom, Australia and France, as well as a handful of others, have been leading the way in this respect. Companies and SMEs in some countries are exploiting this approach to expand business and create jobs, whilst a few governments are using crowdsourcing encourage co-creation events (e.g. innovation camps, “hackathons”, code sprints and apps challenges) to create apps, services and enable various stakeholders to contribute to policy making, public value creation and social innovation (Ubaldi, 2013).

The value of ICTs is not restricted to the executive branch of government. ICTs have also transformed the ways in which the legislature and the public communicate with each other. The Internet, e-mail and mobile phones allow stakeholders to access information and submit views and evidence to legislators in new ways, including blogs and web-forums where people can post their views. The *Red Tape Challenge* launched in April 2001 by the UK Government made use of a designated website for the public to have their say about red tape, and to seek ideas from businesses and civil society by collecting suggestions and examples of unnecessary and obsolete regulations which should be repealed. These mechanisms complement traditional media engagement, as people often obtain information about parliaments and politics from television, radio and newspapers. Issues of concern relating

to legislation are often covered in the media and this coverage can be utilised to call for evidence and opinions.

The use of ICTs provides opportunities for enhancing participation and social inclusion – but also raise important challenges for governments. First is the issue of government accountability when responsibilities and risks are shared with or transferred to citizens. Second is the risk that less vocal citizens or those “willing but unable” do not participate, thereby reducing instead of strengthening inclusiveness. The challenge is to adopt new policies and strategies to harness ICT in order to facilitate forms of public engagement that allow the provision of equal opportunities to all citizens’ groups, including by focusing on using new technologies to increase access, avoiding the creation of new forms of digital divide, and attracting disaffected groups such as youth. Third, there is a need to develop capacity – both of government and citizens – to understand and use these collaborative models effectively.

Moving forward with reform to build inclusive institutions

Sustained pursuit of Inclusive Growth may require significant changes to institutions and political processes in many countries. When it comes to politics and policy, institutions can empower some, while marginalising others. In the economic sphere, they influence the resources and opportunities that individuals and groups can access in seeking to better their lives. Where the “rules of the game” are more exclusive to begin with, promoting inclusion is likely to be harder. Moreover, since institutions usually evolve slowly, they often reflect past distributions of power and wealth, leaving some groups marginalised in terms of access, participation and benefits. The issue, then, is whether current institutions and processes are “fit for purpose” when it comes to pursuing Inclusive Growth. Where they are not, reform is needed to move institutions and processes toward the good practices highlighted in this chapter.

Promoting more Inclusive Growth can often be hardest to realise in the areas it is needed most. The intended beneficiaries of such policies are, by definition, under-represented in the policy process. As a result, their needs or views may be inadequately integrated into the design of reform. This is also important when it comes to implementation. Since policy effectiveness depends in part on social acceptance, even well-intentioned and well-designed reforms can encounter difficulties if the intended beneficiaries feel mistrustful of, or alienated from, the reform process.

The political economy of reform is particularly important for the design and implementation of Inclusive Growth strategies at the national level. As discussed previously, it is important to put in place an inclusive decision making process that is preserved from capture by interest groups, gives voice to various stakeholders, and reflects the needs and demands of the population. In addition, effective policy design needs to be complemented by additional steps so that, once designed, reforms can be implemented successfully, reach the targeted groups and deliver on the intended objectives. OECD work on “making reform happen” points to a number of lessons that are relevant for the pursuit of reforms targeting social inclusion.⁸ In particular:

- **It is important to have an electoral mandate for reform.** It is not enough to win an election or command a majority in the legislature. It also matters a great deal if the government has made the case for reform to the voters ahead of an election. If the electoral process itself discourages inclusion, such processes may need to be reformed

first. Giving voice to outsiders is critical to building the political momentum needed to make other institutions more inclusive.

- **Clear communication of the long-term objectives of reform and inclusive, consultative processes pay dividends over time.** Effective communication with stakeholders involves listening to their concerns and may result in some modification of reform proposals. Institutions that facilitate such communication processes can improve the quality of reform proposals, as well as prospects for their adoption. Inclusive, consultative policy processes are no guarantee against conflict, but they seem to contribute to greater trust among the parties involved. Here, too, basic institutional work may be needed to shore up the policy process, since those whom inclusive policies seek to help may, *ex ante*, be more difficult to reach via communications and consultation processes. They are likely to be less well-resourced, less informed and less organised, and in many cases they may already feel alienated from established institutions.
- **An evidence-based and analytically sound case for reform serves both to improve the quality of policy and to enhance prospects for reform adoption.** It is particularly important to identify strategies for making growth inclusive rather than pursuing inclusion at the expense of growth: this will greatly soften the distributional conflicts involved.
- **Strong leadership – whether by an individual or an institution charged with carrying out a reform – plays a major role as a steward of change.** However, this should not be read as endorsing a top-down approach or a preference for unilateral action. The experience of several countries suggests that successful leadership is often about winning consent rather than overcoming opposition or securing compliance.
- **Pilot programmes and experimentation can be encouraged where best practice is not clear, and/or where learning is required.** Pilot programmes and innovations tried in one place in government (e.g. in a particular ministry or agency, at a sub-national level of government) can help to identify the pros and cons of different approaches, revealing useful practices that can be scaled up and institutionalised.
- **More haste can make for less speed.** Inclusive policy processes can take time, and policy makers may fear that the emphasis on inclusive and consultative processes will delay – or even block – urgent reforms. However, OECD work on reforms in pensions, labour markets and product markets suggests that successful structural reforms take time, and many of the least successful reform attempts under study failed in part because they were undertaken in haste. In a number of cases the rush to act led to erroneous decisions, based on inadequate information, or strengthened opposition to reform because important affected groups were left out of the process (Tompson, 2009). In the long run, inclusiveness may avoid the delays, setbacks and errors that may emerge from closed decision-making processes.
- **Keeping actors on board over time is critical.** The emphasis on avoiding haste stands in contrast to arguments that have long been advanced about the need for reformers to move fast, at times masking their intentions, in an effort to advance reforms before reform opponents can react.⁹ However, such strategies typically prevail when reforms are adopted in crisis conditions and when they bear fruit quickly, as for example, when a stabilisation policy is imposed in the face of hyperinflation and rapidly restores macroeconomic balance. Structural reforms rarely bear fruit so quickly, and the evidence presented in Tompson (2009) and OECD (2010b) across a wide range of policy sectors

suggests that sustained engagement with stakeholders, via inclusive policy making, is often critical to sustaining structural reforms that may need time to mature.

Political strategies are not the only source of change. Economic, social and demographic changes may themselves lead to changes in the distribution of voice and preferences across society, empowering previously marginalised groups. Over time, they are able to make better use of existing institutions as well as to shape new ones. This has been the experience, to a greater or lesser extent, of many countries with respect to women or the growing economic and social clout of immigrants or other minorities. However, the process is not automatic: these underlying changes in the socio-economic landscape may create conditions more favourable to inclusive reforms, but someone still has to make those reforms happen.

Notes

1. See, for example, Chattioadhyaym and Duflo (2004), Volden et al. (2013), Anzia and Berry (2011), and Volden and Wiseman (2011).
2. See, for example, Acemoglu, Johnson, and Robinson (2002), Bowles (2004), Piketty (2006), and Acemoglu and Robinson (2012).
3. These data refer to surveys that ask respondents whether they cast a ballot during the last election, and are compiled by the Comparative Study of Electoral Systems (CSES), an international research programme that collects comparable data on elections. The data include ratios of self-reported voter turnout between different subgroups of the population. These results have to be interpreted with some caution, as self-reported rates of turnout may be quite different from official voter turnouts (OECD, 2011a).
4. See Faguet (2011).
5. See OECD (2007); OECD (2013b).
6. Perception surveys are another method to collect evidence from citizens. Many OECD countries are using them for the purpose of complementing quantitative measurements (i.e. based on the Standard Cost Model) to identify burdensome regulations and assess irritation costs. In these cases, perception surveys deliver information about stakeholders', businesses' and citizens' perceptions of the quality of regulations (OECD, 2010).
7. "Crowdsourcing represents the act of a company or institution taking a function once performed by employees and outsourcing it to an undefined (and generally large) network of people in the form of an open call. This can take the form of peer-production (when the job is performed collaboratively), but is also often undertaken by sole individuals. The crucial prerequisite is the use of the open call format and the large network of potential laborers." (Howe, 2006.)
8. See, in particular, Tompson (2009) and OECD (2010).
9. See Williamson and Haggard (1994); Rodrik (1996); and Arroyo (2008). Pierson (1996) argues that welfare-state retrenchment, in particular, can occur only via a policy of stealth. This view arguably finds support in the experiences of the many countries in which reforms have been successfully implemented with little prior consultation, often in the face of strong public opposition and at times in contravention of the declared policies of the governments undertaking them. See, for examples, Nelson (1990a, 1990b); and Boeri et al. (2006).

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