Structural reforms can be inclusive; it all depends on the details

By Orsetta Causa, Mikkel Hermansen and Nicolas Ruiz, Structural Surveillance Division, OECD Economics Department

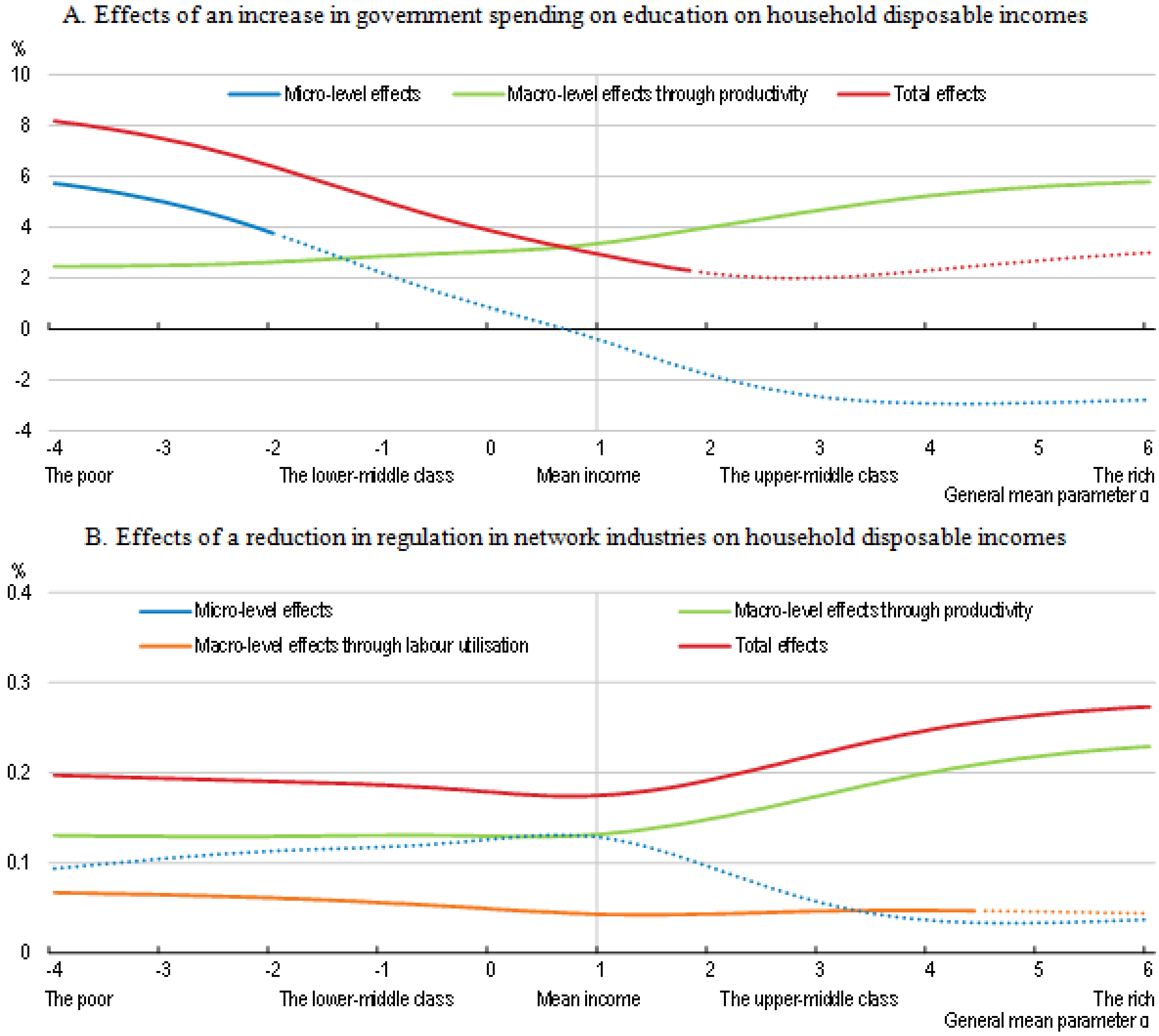
Structural reforms are regularly assessed based on their ability to boost GDP per capita. This emphasis relies on the assumption that higher GDP per capita is systematically associated with rising living standards for the vast majority of citizens. This view is increasingly being challenged. The worrying evolution of income inequality in many countries suggests that distributional considerations need to be more systematically taken into account in policy making. In a nutshell, what are the policy options for making pro-growth policies inclusive?

New research by Causa et al. (2016) sheds some light on this question by adopting a more granular approach to the evaluation of pro-growth policies. *First*, the analysis delivers the effect of reforms on household incomes at the bottom, the middle and the top of the distribution. This helps to better understand the distributional implications from pro-growth reforms. In particular, it allows for distinguishing reforms that boost incomes across the whole distribution but relatively more among the rich than among the poor from those that boost incomes in the middle class and among the rich but have no effect or depress incomes among the poor. *Second,* the analysis considers the channels of macroeconomic growth by decomposing the policy effect into growth in employment and growth in labour productivity. This provides a better understanding of the mechanisms through which policies benefit household incomes at different points of the income distribution.

This new research conveys policy relevant messages for the growth and inequality nexus:

- Most pro-growth policies are good for the middle class inasmuch as they tend to lift all incomes around the middle of the distribution.
- By contrast, a number of pro-growth policies that are good for the middle class can in fact hurt the poorest. This is mostly the case of reforms to social protection and labour market policies. In particular, reductions in the generosity of unemployment benefits and social assistance are found to leave poor households behind even when such reforms generate aggregate employment gains. Policy packages can in this case be designed to mitigate trade-offs between raising work incentives and ensuring income adequacy for vulnerable households, that is, through well-targeted job-search assistance and training programmes with a view to raising employability and pay prospects among those with low skills and the long-term unemployed.
- Other reforms can also have the opposite effects, raising income for everybody but more so for the poor than for the middle class. Such is the case of increasing public spending on education (Chart 1, Panel A), in particular on childcare and early childhood education, as this boosts growth and at the same time enhances women labour market inclusion, resulting in a decline of income inequality.

Figure 1. The distributional impact of structural reforms



How to read this figure: Panel A: An increase in government spending on education (in per cent of GDP) by 1 percentage point is estimated to increase household disposable incomes by 2-8% on average from the poor to the middle class. This total effect can be decomposed along a micro-level effect and macro-level effect through labour productivity. Panel B: A reduction in regulation in network industries (ETCR aggregate, index 0-6) by 1% is estimated to increase household disposable incomes by around 0.2% on average across the distribution. This total effect can be decomposed along macro-level effects through labour productivity and labour utilisation. The micro-level effect is insignificant for all income groups and thus not included in the total effect.

See Causa et al. (2016) for details of the empirical approach and the definition of the effects. Non-significant estimates (at the 10% level) are indicated by dots on general mean curves.

Whether pro-growth reforms act via boosting productivity, employment, or both matters: this shapes their distributional implications by compounding their final effects. For example, spurring productivity by easing barriers to firm entry and competition in product markets produces strong macroeconomic gains which accrue to households at large and are fairly equally shared. Yet this reflects two distributionally-offsetting effects: higher labour productivity, which tends to benefit the most affluent households disproportionately, and higher employment, which tends to benefit the less affluent households disproportionately (Chart 1, Panel B).

So, making reforms for inclusive growth is about exploiting synergies, and designing policy packages to mitigate trade-offs. It is thus all about details. At the current juncture there is a crucial need for more growth but also to make it more inclusive. This is not out of reach as countries exhibit large room for packaging structural reforms to target both growth and equity objectives.

References

Causa, O., M. Hermansen and N. Ruiz (2016), "The Distributional Impact of Structural Reforms", *OECD Economics Department Working Papers*, No. 1342, OECD Publishing, Paris, http://dx.doi.org/10.1787/5jln041nkpwc-en .