Does growth lead to inequality? It depends.

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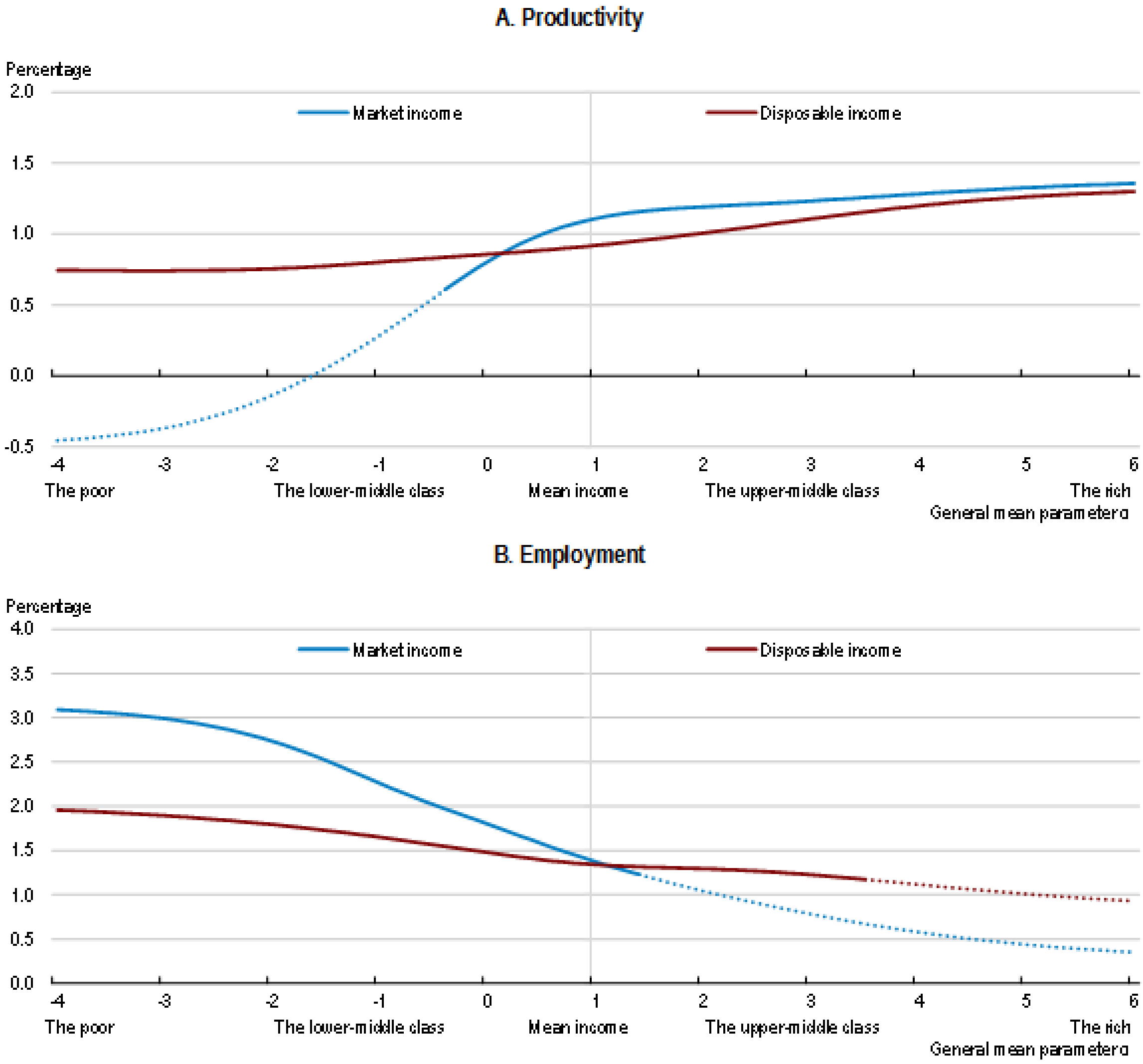
Widespread increases in inequality over the past three decades have raised the question of whether growth in itself is a driver of income inequality. Considering that correlation often tells little about causation, this question is less trivial than may appear at first glance. Indeed, the concomitant rise in GDP per capita and income inequality does not, per se, imply any causal relationship from the former to the latter. Research efforts have offered mixed conclusions so far and the growth and inequality question has been at the centre of a long-standing controversy among economists (Dollar et al. 2015). New OECD research by Hermansen et al. (2016) shows that in order to provide a convincing answer, the question needs to be framed more specifically.

First, the mechanisms that link growth and inequality are likely to differ depending on the *location of inequality*, i.e. at the bottom, in the middle, or at the top of the income distribution (Barro, 2000). Hence, a single inequality measure such as the Gini coefficient may end up capturing relatively unimportant average effects. Second, the mechanisms that link growth and inequality are likely to differ depending on the *sources of growth*, in particular whether growth in GDP per capita is driven by growth in productivity or growth in employment. Third, they are also likely to differ depending on whether one considers income inequality *before or after government redistribution*, that is, inequality in market incomes, i.e. income derived before taxes and transfers, or inequality in disposable income, that is, income after taxes and transfers.

Using a novel empirical framework, Hermansen et al. (2016) shed new light on the old growth and inequality nexus by assessing the impact of growth on household incomes across the distribution, that is, progressively encompassing poor, middle class and rich households. Their conclusion is that that there is no single answer to the growth and inequality question. Labour productivity growth is found to have contributed to rising market income inequality, while this was partly mitigated through government redistribution, on average across OECD countries over the past three decades (Chart 1, Panel A). By contrast, employment growth is found to have had an equalising impact, benefiting mostly and importantly households in the lower part of the income distribution (Chart 1, Panel B). Overall, these two forces have tended to offset each other and resulted in a broadly distribution-neutral impact of GDP per capita growth, on average across OECD countries over the last three decades. So, with reducing inequality remaining a defining challenge of the post-crisis era, promoting job creation is a key policy goal, in particular where employment rates still fall short of pre-crisis levels. But, perhaps more importantly, in looking for ways to revive productivity growth, governments need comprehensive policy strategies to ensure that the gains are more broadly shared across the population.

Figure 1. The distribution of the growth dividends

Impact on household incomes of a 1% increase in productivity or employment



How to read this figure: A 1% increase in labour productivity is estimated to increase mean household market incomes by around 1%, on average across OECD countries over the last decades (Panel A). For poor and lower-middle class households (captured by a general mean of market incomes emphasising lower incomes relatively more, see Hermansen et al. (2016) for details), an insignificant effect (indicated but the dotted lines) is estimated for market incomes, while the effect is significant and slightly above one for the upper-middle class and rich households. By benefitting only the more affluent households, labour productivity growth is thus found to increase market income inequality. For household disposable incomes, i.e. after taxes and transfers, labour productivity growth also benefits the least affluent households, but relatively less than the more affluent households. By contrast, a 1% increase in employment is found to increase both household market and disposable incomes by 2-3% among lower-middle class and poor households (Panel B), while having no significant effect on the most affluent households. Hence, employment growth is found to reduce income inequality.

References

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