



# INCLUSIVE PROSPERITY

*How reducing income inequality can  
enhance productivity and growth*

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*There is a growing consensus that Australia's potential or trend rate of real gross domestic product (GDP) has fallen. Led by Glenn Stevens, Governor of the Reserve Bank of Australia (RBA), the economics profession is digesting the rising probability that the trend pace for annual GDP growth is now a touch under 3 per cent, where past research was almost unanimous that potential growth was around 3.25 per cent.*

*There are many reasons raised why this ratcheting down in the limit to Australian economic growth may have occurred, with rising income inequality rating highly. Why?*

#### **First, greater equality can lift overall demand.**

Academic research on the link between income inequality and economic growth has been prolific in recent years with the conclusions perhaps best summarised in the following stylised example.

Let's assume that an economy gains \$1 billion of income. At one extreme of inequality, \$200 million could accrue to each of the five richest people; at the other extreme, the 1 million poorest people could be given \$20 per week for a year.

If this economy was Australia, each of the five richest people would start from the position of having existing wealth of at least \$6.9 billion. An extra \$200 million would be unlikely to make a material difference to their spending on food, clothing, shelter, education, entertainment or holidays, for example. It may, at the margin, feed into their investment decisions, but the overall injection and circulation of that extra \$1 billion would yield a small addition to the rate of national economic growth.

For the very poor people, each with wealth of close to zero and an income invariably below \$400 per week, the extra \$20 a week or \$1,000 over the course of a year would almost certainly all be spent. This is because for the poorest in society, what economists call the "marginal propensity to consume"

is high. With the extra \$20 a week, the poor might buy new clothes, food or shelter with the extra cash – but we know they won't simply save it. In fact it doesn't really matter where the money is spent in this example; the key point is that the rate of economic growth would increase and be significantly more than that if the money accrued to the five richest individuals.

It is noteworthy that this benefit of equality extends to middle income earners who, according to Andrew Leigh, have a similar marginal propensity to consume as low income earners.<sup>1</sup>

The end point of this example is to show that a move towards greater income equality should increase spending. In turn, a move towards greater income inequality should enhance economic growth compared to the experience of greater inequality.

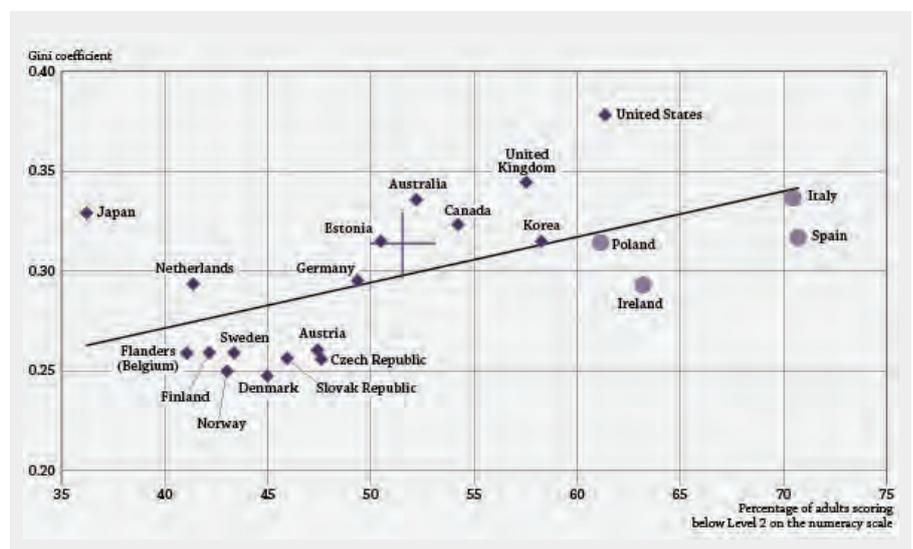


Second, greater equality lifts education and skills.

This aspect of income inequality and its impact on economic growth and productivity is through less direct or obvious effects and policy choices.

According to several OECD research reports <sup>2,3</sup>, the greater the degree of income inequality, the lower the level of educational attainment and skill in the general population. In the example of numeracy, the more numerate a society, the lower the Gini coefficient (greater equality).

Relationship between the percentage of adults with low proficiency in numeracy and the Gini coefficient



*“inequalities in well-being among adults translate into inequalities in opportunities for their children”*

Why? One of the OECD’s reports concluded that

*“inequalities in well-being among adults translate into inequalities in opportunities for their children”.*

In other words, greater income equality provides greater educational opportunities for young people. With that, they will derive higher incomes on average over the course of their life than if inequality was entrenched. Per capita incomes in countries with poor education and academic attainment are lower and those countries have weaker economies, on average, than those with higher education attainment and skills.

Spending money on access to widespread education, especially for the poor, is good for economic growth. Generating greater income equality, allowing people to invest in their own education and skills, is even better.

**Third, greater equality is associated with stronger productivity growth.**

James Galbraith has also found that a country's economic performance improves with greater equality, noting

*“more egalitarian societies tend to have lower steady-state unemployment. They also tend to have higher rates of technical progress and productivity growth.”*

He continues, *“a more equal wage distribution encourages specialisation in higher value-adding industries, while low wage, low value-adding industries cannot compete.”*<sup>4</sup>

This unleashes a virtuous circle of competition to add value, rather than a vicious cycle of competition to cut costs.

For any macroeconomist or policy maker with an objective of maximising a society's well-being, lower unemployment and higher wages in a 'steady state' or at full employment is the fundamental objective. Galbraith's thesis means that greater equality via access to education will deliver higher productivity, wages and employment which combine to underpin a higher rate of potential economic growth.

**Fourth, greater equality delivers better innovation.**

Galbraith's findings were further supported in an IMF research

paper<sup>5</sup> which made the linkage from educational attainment in a society to economic growth, through a series of steps. It found that productivity growth was enhanced through greater investment in research and development which in turn was positively linked to a higher level of educational attainment of the workforce. Those conducting the R&D needed a pool of highly skilled workers which fed back into educational institutions devoting more resources to education students.

**Fifth, greater equality improves health and lifts workforce participation.**

A reduction in inequality as a catalyst for faster economic growth also applies to access to health services. A research report from academics at the National Bureau of Economic Research in the US found that

*“good health has a positive, sizable, and statistically significant effect on aggregate output.”*<sup>6</sup>

It found that *“healthier workers are physically and mentally more energetic and robust. They are more productive and earn higher wages. They are also less likely to be absent from work because of illness”* as the basic underpinning of the link between access to health care and economic growth.

It is encouraging that the academic findings linking greater equality to higher productivity and stronger

economic growth are intuitively appealing. It makes sense that greater equality enables higher educational attainment. This leads to a smarter, more highly skilled population which in turn leads to higher average incomes and a higher rate of economic growth. It is also logical that a healthier population means that workers will be able to work more, cost the state less to care for and as a result, add to economic output and productivity over the medium to long run.

*Put simply, the research shows a strong consensus that greater equality lifts demand, ensures a smarter and healthier workforce as the general population has greater access and opportunity to maximise educational attainment and health, and strengthens productivity and innovation.*



## POLICY – What Are We To Do?

The Australian Treasury has as part of its mission

*“to improve the wellbeing of the Australian people, including by achieving strong, sustainable economic growth”.*

There is no mention of equality in the full mission statement (pages 7 –9 of the 2013–14 Annual Report), although it does note that the department’s Revenue Group provides advice on the “distributional impacts of changes to tax policy”. This is where the policy decisions on education, tax policy, university funding and healthcare are so vital, not just in terms of their impact on the budget bottom line, but importantly on the growth prospects for the economy through addressing issues of equality.

At a time when the Australian and global economy are still reeling from the nasty hangover of the 2008–2010 banking and financial crisis, policy makers are finding it difficult to find the definitive policy prescription to kick-start a stronger expansion. Near-zero interest rates from central banks, often with quantitative easing, are not leading to a robust or lasting pick-up in economic activity.

Fiscal policy around the world is hamstrung by persistently large budget deficits and massive levels of government debt. It is considered difficult for governments to implement fiscal stimulus when net debt levels are already close to or above 100 per cent of GDP. Some countries even try to manipulate the exchange rates to give them a competitive advantage but this is obviously not a fix for global growth as it is a zero sum game – one country’s currency depreciation is another country’s currency appreciation.

So what is left in the policy toolkit to lift growth? Rather than monetary and fiscal stimulus as the drivers or a stronger economy, the solution appears undoubtedly to be policies that tackle inequality.

Progressive taxation policy and measures to increase wages can deliver short-term results, with policies that improve the quality and access to education and health more medium- to long-term proposals.

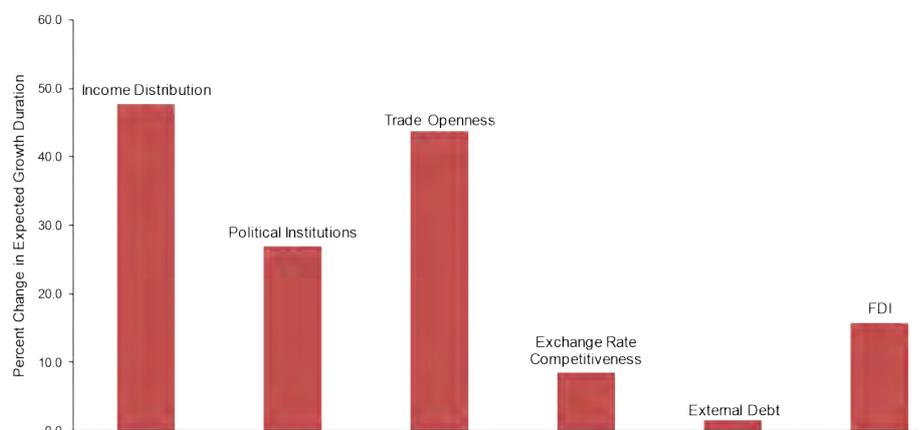
Income and wealth redistribution, if implemented correctly and in a measured way, can be at zero cost to the government’s budget bottom line. So do labour market policies aimed at strengthening the bargaining power of employees to win wage increases which keep up with productivity growth. Eliminating tax expenditures and subsidies to higher-income people can actually increase revenue.

Another way of looking at the issue is to acknowledge that there is a trade off between income equality and economic growth. The trade off that may need to be considered is that we can have either

high inequality in society and weaker economic growth or we can have high equality and faster growth.

Relatedly, the IMF researched the characteristics that fed into prolonged periods of economic growth<sup>7</sup>. In other words, what are the factors that lower the risk of a country falling into recession? Of the countries and variables assessed, a more equal income distribution was the main factor, followed by trade openness. (External debt had next to zero impact on the duration of an economic expansion.)

Effect of Increase of Different Factors on Growth Spell Duration





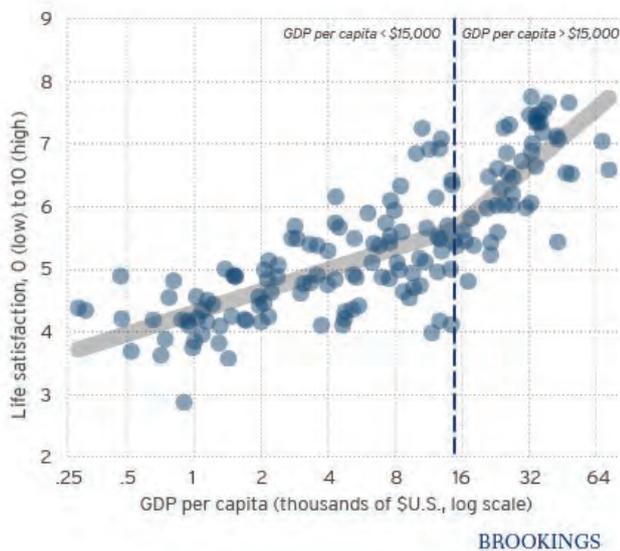
This would require a recasting of a lot of mainstream economic thinking which is more narrowly focused on the size of budget deficits and level of interest rates as drivers of growth. Slicing of the proverbial economic pie differently, towards a redistribution to the middle and the poor, can simultaneously increase the size of the pie.

One last point...

And a final note. There is an unambiguous correlation between income and happiness. Justin Wolfers, Professor of Economics & Public Policy at the University of Michigan, produced these wonderful graphs which plotted incomes against a measurement of Life Satisfaction<sup>8</sup>.

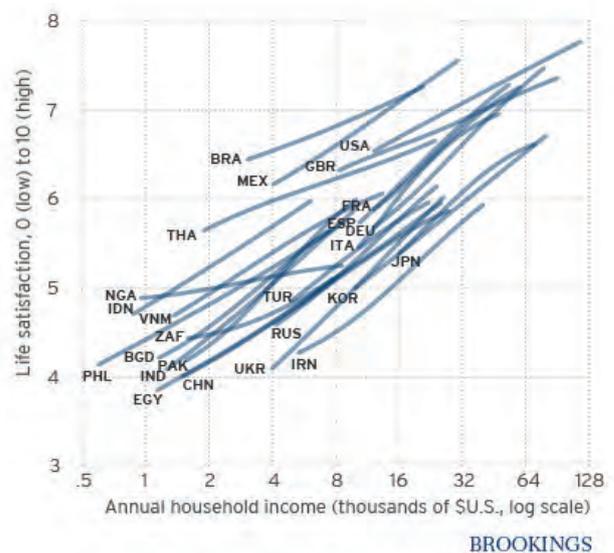
Across nations, the higher per capita GDP, the greater the degree of life satisfaction or as Wolfers called it, "happiness".

Income and well-being: cross-country  
(Gallup World Poll, 2008 to 2012)



Wolfers also looked at within country annual household income and life satisfaction. The findings for the 25 most populous countries showed the same trend – as annual household incomes rose, life satisfaction also increased.

Income and well-being: within-country comparisons  
(25 most populous countries; Gallup World Poll, Dec. 2007)



All of which means that policies that can boost incomes and lift the rate of productivity and economic growth will make people happier. Less inequality will make people happier. Glenn Stevens implicitly agreed, saying that

*“If we care about well-being in the broadest sense, we should care about things that affect potential output per head.”<sup>9</sup>*

*And isn't that what economic policy should be all about? ■*

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## Endnotes

1. <http://andrewleigh.org/pdf/fiscalstimulus.pdf>
2. <http://oecdeducationtoday.blogspot.fr/2014/05/poorly-skilled-adults-neglected-factor.html>
3. [http://www.keepeek.com/Digital-Asset-Management/oecd/economics/how-s-life-2015/summary/english\\_c7adaf59-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/economics/how-s-life-2015/summary/english_c7adaf59-en#page1)
4. Quoted in [http://www.aph.gov.au/About\\_Parliament/Parliamentary\\_Departments/Parliamentary\\_Library/pubs/BriefingBook44p/EconEffects](http://www.aph.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/BriefingBook44p/EconEffects)
5. <http://www.imf.org/external/pubs/ft/sdn/2011/sdn1108.pdf>
6. <http://www.nber.org/papers/w8587.pdf>
7. <https://www.imf.org/external/pubs/ft/wp/2015/wp15116.pdf>
8. Life Satisfaction or happiness was taken by Wolfers to be: Gallup question wording: “Please imagine a ladder with steps numbered from zero at the bottom to ten at the top. Suppose we say that the top of the ladder represents the best possible life for you, and the bottom of the ladder represents the worst possible life for you. On which step of the ladder would you say you personally feel you stand at this time, assuming that the higher the step the better you feel about your life, and the lower the step the worse you feel about it? Which step comes closest to the way you feel?”
9. <http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22committees%2Fcommrep%2F468d534f-c605-425d-96b9-0906e3278a7d%2F0001%22>

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