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Inequality, Economic Growth and Prosperity

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Income inequality has increased substantially in many OECD countries over recent decades, after a long period of decline after the Second World War. Until relatively recently, concerns expressed about this reversal focused primarily on the societal impacts of greater inequality, for example the effects it may have on health, crime, or family structures, or indeed on trust and social cohesion. Even before the crisis, the increasing concentration of income towards the top also was being linked with the stagnation in ordinary living standards seen in some countries, including the UK and the USA. With the onset of the financial crisis and subsequent recession and the slow and patchy recovery, however, rising inequality is also increasingly seen as being of direct relevance to macroeconomic performance: it may well be among the underlying and proximate causes of the crisis, be serving to dampen recovery, and represent a serious threat to long-term growth and prosperity. Inequality may thus be centrally implicated in the failure to generate sustainable growth and rising prosperity for ordinary working families. Such concerns now go well beyond academic studies and regularly feature in speeches by politicians, central bankers, financial market analysis and commentary, and media debate.

The extent to which income inequality has grown is now widely known, though the relative importance of the variety of driving forces and factors producing these trends is less clear. The share of total (gross) income going to the top 1% has become one of the most widely quoted indicators: in the USA this has risen from 8% in the late 1970s to over 19%, while in the UK it rose from 6% to 13% over the same period. The Gini coefficient, the most widely-used summary measure of inequality across the distribution as a whole, has risen by about

24% in the USA and by considerably more in the UK over these years, albeit from a much lower base and with that increase concentrated mostly in the 1980s.

Various potential channels of influence by which this much higher level of inequality could impact on the macroeconomy, both in the shorter and longer term, have been advanced. As far as contributing to the onset of the financial and economic crisis is concerned, the causal chain put forward most often is that increasing inequality combined with stagnation in real wages and median household income pushed households – notably in the UK and the USA - to borrow beyond their means in order to sustain consumption. This served to fuel the run-up in household debt, feeding into the toxic combination of reckless lending, real estate bubble and financial innovation that brought the banking sector to the edge of the precipice in 2008.

The potential importance of inequality in dampening recovery from the recession, much commented on at present, relates primarily to its impact on household consumption. Increased inequality is regarded as reducing overall aggregate demand compared with what it might otherwise be or with previous recoveries, because the marginal propensity to consume of high-income households is lower than other households. This is compounded by the fact that middle and lower-income households are attempting to deal with the overhang of mortgage and credit card debt (and in the USA debt from student loans), even if not 'under water' with negative housing equity. The strength of the stock market, on the other hand, may have a positive 'wealth effect' on consumption but only affects wealthier households, and even there the propensity to consume has been tempered by uncertainties about the strength and sustainability of the recovery – while inequalities in wealth are increased, not least by the 'Quantitative Easing' by central banks in the UK and USA, and now by the European Central Bank, which serves to boost asset prices.

The channels through which inequality may undermine longer-term growth are more varied and diffuse. Extending the logic applied to its postulated role in the crash, it could contribute to a continuation of similar cycles of boom and bust via the need to continually expand credit to middle and lower-income households if these are to see improving real

incomes, in the absence of sufficient growth in real wages. Via its impact in holding back aggregate consumption, it could undermine investment in new or replacement capital stock and thus limit the growth in the economy's productive capacity, rather than seeing a virtuous cycle whereby widely-diffused increases in income underpin demand across the board and bring forth correspondingly broad-based and sustained investment.

Another potential channel of influence on productive capacity relates to the workforce: if the ability to invest in education and skills becomes more stratified by income, this could produce a less-educated workforce, less adaptable in the face of globalisation and technological change, thus reducing potential growth. In the longer term, greater barriers to socio-economic mobility from one generation to the next would mean a loss of potential additions to growth as those affected fail to reach their full productive potential. Such considerations are at the core of the arguments that a strategy focused on 'Social Investment' is now required, which have found a sympathetic audience at European Union level, emphasising the long-term benefits from improving education from early childhood onwards, together with training and labour force activation, as the way to achieve greater and more inclusive growth.

At a broader level, greater inequality in income – and wealth – could undermine the capacity of the economy to grow by entrenching the power of existing elites and by exacerbating pressures for short-term and counter-productive responses to stagnating living standards for the many. The capacity of those at the top of the distribution to influence policy to protect their economic interests (including their ability to capture unproductive 'economic rents') may be enhanced, increasing barriers to entry and reducing incentives to innovate. At the same time, it may serve to increase political pressures for greater protectionism in trade and with respect to immigration, and to protect existing jobs/industries by other means, all acting to stifle innovation and 'creative destruction'. Indeed, the sorts of concerns more usually expressed about the potential impact of inequality in middle- and low-income countries in undermining the political and legal institutions and social trust that are now recognised as key to growth are now being raised with respect to rich countries with high and growing inequality. As the recent IMF study by

Berg *et al* (2014) put it, “inequality can undermine progress in health and education, cause investment-reducing political and economic instability, and undercut the social consensus required to adjust in the face of shocks, and thus that it tends to reduce the pace and durability of growth”. (While much of Thomas Piketty’s recent magnum opus *Capital in the 21st. Century* relates to the drivers of inequality and how low growth may exacerbate it, such concerns about the impact of inequality on growth are echoed in his work).

Long-standing arguments that some degree of inequality is required to provide the incentives essential to a vibrant economy have not gone away, of course, nor have the associated concerns about the potential negative impact on growth of measures intended to produce a more equal distribution – including direct redistribution via taxes and transfers. The attention given to the IMF study on redistribution and growth, with its conclusion that redistribution appears generally benign in terms of its impact on growth, is particularly striking in that context: rather than assuming a particular relationship between inequality (or redistribution) and economic growth on the basis of theory-based reasoning alone, there is more openness to (also) ‘letting the data speak’. This also clearly has a direct bearing on debates about the level of taxation that is sustainable and about the capacity of governments to raise revenue in a way that does not undermine growth and employment. Here evidence from microeconomic studies of the behavioural responses of individuals and firms to different levels and structures of taxation are clearly highly informative, but so are more aggregate-level comparisons of the variation in taxation levels and structures over time and across countries together with growth and employment outcomes. These do not suggest any straightforward consistent relationship whereby raising the total tax ‘take’ reduces growth and employment, or that reducing taxes produces better outcomes in those dimensions. Indeed, given the complexity of tax structures and the channels through which they, together with the spending they finance, feed through to the macroeconomy, the notion of a simple and widely-applicable ‘tipping-point’ beyond which the net impact on the economy of increasing taxes and spending will be negative is itself not a particularly helpful one.

The complex webs of inter-relationships between inequality, growth and living standards clearly need to be investigated in much greater depth - not least because much of the available empirical analysis relates to the USA with its highly distinctive features, both economically and societally, and to only the recent crisis or the even more recent period of slow recovery. There is an urgent need for a more broad-ranging analysis of the causal channels which have been postulated, covering a much longer time period and a range of countries and experiences. In doing so, particular care needs to be exercised to distinguish and adequately capture different aspects of inequality that are often confounded –

inequality in income versus wealth, for example, or trends at the very top versus those throughout the bulk of the distribution. In addition, it is also essential to incorporate both inequality and trends in real incomes and living standards: many of the postulated channels relate to a context where inequality is rising and real incomes stagnating, but would operate rather differently where both inequality and real incomes throughout the distribution were increasing. Such a broad-ranging investigation is at the core of the Employment, Equity and Growth Programme recently launched at the Institute for New Economic Thinking at the Oxford Martin School, in partnership with Oxford's Department of Social Policy and Intervention and the Resolution Foundation.

While current concerns are primarily focused on the aftermath of the crisis and pace of recovery from it, with real incomes for middle and lower income households in the UK in particular lower than they were a decade ago while the wealthy have continued to prosper, understanding the complex interactions between inequality and growth may well hold the key to long-term growth and widely-shared prosperity.

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