Executive Summary

Eight years on from the start of the economic and financial crisis, the international economic context remains challenging, with growth still modest in advanced economies and continuing to slow in key emerging markets. While this weakness is in part cyclical, reflecting the realities of the post-crisis environment, it also results from a worrying slowdown in productivity growth which predates the crisis. Indeed, some 90% of OECD countries experienced a decline in trend labour productivity growth after the turn of the millennium, and the slowdown has now also spread to emerging market economies, despite their comparatively low productivity levels and continued scope for catch up.

Of equal cause for concern is the fact that this decline in productivity growth has played out against a global backdrop of rising, or persistently high, inequalities of income, wealth and well-being. In 2012, the average income of the top 10% of earners in the OECD area grew to just under 10 times that of the bottom 10%, up from around 7 times in the mid-1980s. In terms of wealth, the situation is considerably starker, with the top 10% controlling half of all total household wealth in 2012 in the 18 OECD countries with comparable data.

Among the myriad challenges facing our economies, few pose greater obstacles to better economic performance than the productivity slowdown and the rise in inequalities. Both have been exacerbated in recent years, as the climate of low investment and high unemployment bequeathed by the crisis has taken its toll, but they also reflect more fundamental challenges with the way our economies function.

In such a context, we can no longer take it for granted that technological advances, and the related innovations in processes and business models, will automatically lead to better economic performance and stronger productivity growth. At the same time, there is no guarantee that the benefits of higher levels of growth, or higher levels of productivity in certain sectors, when they materialise, will be broadly shared across the population as a whole. On the contrary, there is a risk of a vicious cycle setting in, with individuals

with fewer skills and poorer access to opportunities often confined to operate in low productivity, precarious jobs, and - in many emerging-market countries - in the informal economy. This reduces aggregate productivity, widens inequality, and ultimately undermines policy efforts to increase productivity and growth.

This report on the ***Productivity-Inclusiveness Nexus*** gathers the most recent empirical evidence on the main factors behind slowing productivity gains and rising inequality; it suggests possible common foundations and linkages between these two trends; it draws preliminary conclusions on the type of policy packages that are needed and on the implications for policy making, and it also suggests the specific areas where more research may be needed.

The main message of this report is a call for policy makers to adopt a broader, more inclusive, approach to productivity growth that considers how to expand the productive assets of an economy by investing in the skills of its people and providing an environment where all firms have a fair chance to succeed, including in lagging regions. The overriding aim behind this is to broaden the productive base of the economy to generate strong and sustainable future productivity gains that everyone is empowered to contribute to, whilst also ensuring that productivity growth benefits all parts of society, in terms of improved living standards and opportunities. Achieving this will require a comprehensive policy framework to account for the multiple interactions between inequalities and productivity and how these interactions play out across countries, regions, firms and between individuals. Such a framework can help policy makers to put in place *ex-ante* and *ex-post* measures to promote synergies and deal with trade-offs when productivity policies impact on inequality.

The report is organised as follows:

Chapter One examines the productivity slowdown and the apparent dispersion between frontier and non-frontier firms:

- The failure to translate rapid technological change into commensurate productivity growth reflects a mix of cyclical and structural factors. One factor reflecting such a mix has been persistently weak investment in physical capital: in most advanced countries, the recovery in non-residential investment is lagging behind that of GDP, particularly so among European countries. Chief amongst structural factors are those that have led to the growing dispersion in productivity performance between leading firms and their non-frontier counterparts within countries and sectors. For instances, the 2000s saw labour productivity at the global technological frontier increase at an average annual rate of 3.5% in the manufacturing sector, compared to just

0.5% for non-frontier firms. The gap was even more pronounced in the services sector.

- There are several, possibly complementary, explanations for the dispersion in productivity growth. Possible contributing factors include: the growing capture of rents by frontier firms; the ability of these firms to attract the limited pool of highly skilled workers with new sets of horizontal skills required to cope with the rapid pace of innovation, and the lingering presence of poorly-performing firms, that have remained in the market rather than closing down, trapping valuable resources in unproductive activities. All of these may have contributed to the slowdown in the pace of diffusion from the productivity frontier to the rest of the economy.

- Structural settings limiting competition, discouraging firm entry and exit, and leading to skills mismatch may have contributed to each of these phenomena. The extent and combined impact of each of them likely varies across different countries and will require further investigations.

Chapter Two looks at widening and persistently high inequalities of income, wealth and well-being:

- The growth in income inequality witnessed in the OECD over the last three decades reflects both a surge in income at the top, especially the top 1%, and much slower income growth around the median or stagnation at the bottom.

- A main driver has been an increased dispersion in labour and capital earnings. Beyond the impact of the crisis which hit the incomes of those at the bottom hardest, this underlying dispersion in earnings seems to have been driven by long-term structural adjustment engendered by technological progress and changes in labour market institutions and policies. In particular, new technologies have placed a premium on high-skilled workers - the so-called ‘skill-biased technological change’ hypothesis. Moreover, they may have led to job polarisation and a hollowing out of the middle class. It is also related to what happens at the top of the income distribution, with wealth inequalities being seven times higher than income inequalities, on average in OECD countries.

- Inequality is not only a matter of income or wealth; there is also great divergence in outcomes across a broad range of well-being dimensions in OECD countries. The better-off everywhere report superior health levels, benefit from greater access to job opportunities, and can expect their children to attain better educational performance and acquire higher levels of skills, including social and emotional skills that put them in better position to interact

with a demanding work environment. In many other areas too, from access to quality public services, to opportunities to succeed in life, important components of well-being tend to be correlated with and compounded by income inequality.

- Furthermore, these inequalities tend to feed off of each other, considerably limiting the ability of part of the population to fulfil their productive potential and improve their lives. This is especially the case in disadvantaged regions and in poor neighbourhoods of large cities. The extent of this divergence in well-being outcomes has important implications for policies aimed at helping people to fulfil their productive potential.

Chapter Three explores the potential linkages between productivity and inequality, considering the latest empirical evidence on possible linkages and policies that exacerbate both trends, and whether there are common root causes, whilst also setting out the prospects for future work:

- The effect of inequalities in areas like income, education, training opportunities, health, and access to quality jobs or new technologies, tend to feed off each other and may also reduce aggregate productivity and growth. In other words, the income groups that accumulate disadvantages face economic and social failure. In particular, higher income inequality results in fewer people in the bottom 40% of the population investing in skills, and thereby worsens inequality and reduces productivity growth.

- In many instances, the obstacles standing in the way of broader productivity gains also contribute to wider inequality. There is some evidence that growing productivity dispersion across firms has contributed to widening of the wage distribution over the past two or three decades.

- The growth of the digital economy, in particular, raises new challenges for jobs and skills, with a risk of a persistent digital divide between those that have access to the technology and the related skills and those that do not. At the same time, digitalisation provides new opportunities for more inclusive productivity growth, e.g. by reduce the costs of acquiring skills, facilitating entrepreneurship or gaining access to financial markets.

- Rent capture by frontier firms and the underutilisation of resources may also have slowed the diffusion of innovation and limited productivity gains while entrenching inequalities of income, not least by trapping workers in unproductive activities and low-quality jobs and producing “winner takes all” dynamics in the economy.

- It is also plausible that the growing weight of finance in the global economy in recent decades has compounded rising inequalities and diverted investment away from productive activities, while resulting in a higher concentration of wealth at the top of the income distribution. At the same time, small and medium size enterprises and individuals with low level skills are less likely to have access to finance to support their economic activities.

- Individuals, firms and regions that have been left behind and that have not been able to acquire the assets and tools to become more productive subsequently go on to become a drag on economic growth and, more importantly, to accumulate disadvantages that perpetuate lost potential across generations. Regions that have fallen behind fail to attract investment and economic activity, due to a lack of infrastructure, skills and connectivity, but this ends up creating a spiral of diminishing potential. Here too, there is a vicious cycle at play: a lack of public investment in necessary infrastructure reduces regions' attractiveness to private investors, and therefore harms their capacity to increase tax revenues. This impacts their ability to invest in quality public services such as health, security, education, innovation. An agenda for inclusion and productivity is therefore key.

- The various mechanisms and policy settings that have led to such dynamics will need to be explored further. They likely vary across countries. But it is clear already that policy settings and regulatory frameworks across a broad range of areas, including product, financial and labour market regulations, innovation policies, and skills policies may be producing suboptimal outcomes, both in terms of productivity and inclusiveness.

Finally, **Chapter Four** looks at the implications for policy.

- Better understanding the links between productivity and inclusiveness, their possible correlation or common causality, as well as how different outcomes result from distinct policy and regulatory settings, is key to developing a strong agenda for addressing the nexus. The overarching objective is to identify win-win policies that could deliver both improved inclusiveness and productivity growth.

- Ensuring that all individuals, firms and regions are empowered to both contribute to improved productivity growth and benefit from it in terms of improved living standards and that all firms have an equal shot at thriving and contributing to higher productivity growth is key to addressing the productivity-equality nexus:

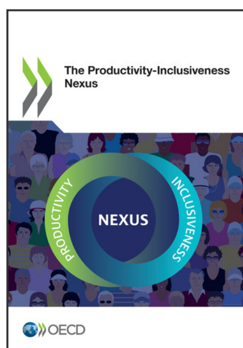
- It first means looking at policies aimed at ensuring that all individuals are equipped to, and supported in, fulfilling their productive potential with adequate investment in skills and health and good opportunities for quality jobs. Inequalities in terms of access to education have decreased to a large extent given the expansion both at the school and University levels. However, differences in quality have greater implications today than ever before given the increased demand for highly skilled people that knowledge based societies and the pace of technological change have created. Policies at the individual level should also include an adequate social safety net and labour market activation policies. Focussing on the bottom 40% who have fewer such opportunities is particularly important and will require reducing the barriers they face in accessing life-long learning, digital technologies, innovation, finance, and entrepreneurship.

- Such policies can work in unison with measures aimed at firms to support innovation and experimentation at the frontier and its diffusion throughout the economy, in areas related to: skills, labour, competition, product market regulation, financial regulation, innovation and regulations related to the corporate sector.

- The regional and urban levels are key. While many productivity-promoting policy interventions are "spatially blind", others have an important place-based dimension. For instance, local conditions are crucial to the effectiveness of policy efforts to improve information about labour-market conditions and ensure more effective training or subsidies to employers. For similar reasons, economy-wide policies aimed at increasing skill levels must often undergo local adaptation to be effective. In addition, regional and urban policies can do much to reduce or remove the barriers to opportunity faced by disadvantaged groups that are related to housing and transport. Finally, regional development policies also promote innovation diffusion to lagging regions.

- The details of policy packages that deliver stronger and broader based productivity growth and reduce inequality will depend on each country's specific circumstances, governance and institutional settings. This means recalibrating traditional 'silo' policies to address these challenges. Indeed, in all countries, designing and implementing these policy packages require a renewed approach to policy making where different government departments, agencies and ministries work together to deliver joined-up solutions and where the regional and spatial dimensions of policies are taken into account. Mechanisms to strengthen public governance, including a whole-of-government approach, and reinforce public institutions and avoid rent seeking and corruption are especially important.

Given the global nature of these challenges, deepening international collaboration and co-ordination will be required in a number of areas, including tax and innovation policies.



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