Foreword

We have reached a pivotal moment for the world economy. Eight years on from the start of the financial crisis, weak trade growth, sluggish investment, weak demand, and a slowdown of economic activity in emerging economies continue to drag on global growth. As policy makers face up to the realities of an ever more complex and inter-connected world, there is a need to look again at how our policy frameworks are configured in order to address multiple challenges. The moment is ripe for new solutions, and the first step has to be putting people's well-being back at the centre of the policy efforts. In the spirit of the OECD's *New Approaches to Economic Challenges* (NAEC) project and the *All on Board for Inclusive Growth* initiative, this is precisely what this report on the ***Productivity-Inclusiveness Nexus*** sets out to achieve.

This report explores two troubling trends that add to the challenging global outlook: the slowdown in productivity growth, and the rise in inequalities of income, wealth, well-being and opportunities.

The slowdown in productivity growth that has been seen in many advanced economies over recent decades has in part resulted from weak global demand in the aftermath of the crisis, a persistent fall in investment in physical capital, and the decline in business dynamism. But there may be other more structural issues at play. The period since the turn of the millennium has seen pronounced divergence in productivity growth rates between 'global frontier' firms - which have continued to register strong productivity gains - and the laggard firms. The report highlights how this divergence between the productivity performance of global frontier firms and others may have resulted from a breakdown of the 'diffusion machine' as the pace at which innovations spread from the frontier throughout the economy slowed. It notes that several structural factors may have played a part in this, with skills mismatch singled out as playing an important role in trapping valuable human resources in un-productive activities dragging on productivity growth and exacerbating inequalities.

But the productivity slowdown is only one part of the story. The report also charts the rise in income inequality seen across several OECD countries that has come to stand at levels unprecedented in the post- war era. Today, the average income of the richest 10% in the OECD is around 9.5 times that of poorest 10%, up from just 7 times 25 years ago. In terms of wealth, the situation is markedly worse, with the top 10% controlling almost half of household assets in 2012. Yet inequalities are not just a question of wealth and income. The OECD's work on Inclusive Growth has highlighted the multidimensional nature of inequalities, demonstrating how low income groups and deprived regions accumulate disadvantages with poorer access to quality education, jobs, health and infrastructure. This perpetuates a vicious circle of exclusion resulting in wasted talent, lower aggregate productivity growth and even greater inequalities. Nowhere is this more acutely felt than in education: in the OECD area adults aged 25-64 with tertiary education have lower unemployment rates than their worse educated counterparts, are more likely to be in the labour force in the first place, earn higher salaries, enjoy good health and even live longer.

The *Productivity-Inclusiveness Nexus* sets out the latest OECD evidence on each of these trends and examines how they may be interlinked. It explores how divergent productivity growth rates may have contributed to rising inequality of incomes between workers, as large increases in the "sorting" of workers across firms has led to the most productive workers increasingly working together and for the most productive firms. It outlines how the increased prevalence of knowledge-based capital and digitalisation may have unleashed winner-take-all dynamics in key network markets leading, in some instances, to an increase in rent seeking behaviour, and that competition frameworks need to be revised in the context of the digital economy. It discusses how the growing weight of finance in the global economy may have compounded rising inequalities and diverted investment away from productive activities. It also emphasises how the rise in inequality over the last three decades has negatively affected human capital accumulation amongst disadvantaged groups.

In this context, we cannot take for granted that technological advances, innovation and entrepreneurship will automatically lead to stronger, more sustainable growth. Nor is there any guarantee that the benefits of higher levels of growth or productivity – if and when they emerge – will be broadly shared across the population.

Making the *Productivity-Inclusiveness Nexus* work for all will require a deeper understanding of the multiple interactions between inequalities and productivity, and how these interactions play out across countries, regions, firms and between individuals. Ultimately, however, it is policies that will make the difference. This will call upon governments to break down policy silos to focus on the range of win-win policies that can reduce inequalities and support productivity growth simultaneously, thereby creating a virtuous cycle for inclusive and sustainable growth. It will also require efforts to ensure that one goal is not pursued at the expense of the other. Adopting a Nexus framework for promoting more inclusive productivity growth can ensure that policy levers are, ex-ante, coherently aligned to harness self- reinforcing synergies between policy domains whilst providing a clear indication, ex-post, of how compensatory measures can best be enacted when trade-offs occur.

In concrete terms this will first call for a new approach to boost productivity at the individual level so that everyone has the opportunity to realise their full productive potential. Expanding the supply of skills in the population through more equal access to basic quality education is crucial, but not enough. With rapid technological change, skills need to keep up with the demands of the market to avoid the skills mismatches which have contributed to the productivity slowdown. A broad strategy is also needed to ensure a better functioning of the labour market, promote job quality, reduce informality, to allow for the mobility of workers and inclusion of underrepresented groups such as women and youth, and to promote better health outcomes for everyone.

Second, for people to realise their full productivity potential, businesses have to realise theirs. While heterogeneity among firms is a normal phenomenon, the widening dispersion we observe and the implications it has for aggregate productivity and workers is a cause for concern. The larger the share of business that can thrive, the more productive and inclusive our economies will be. Achieving this requires a reassessment of competition, regulatory and financial policies to ensure a level playing field for new firms relative to incumbents, and policies to facilitate the diffusion of frontier innovations from leading to lagging firms. While highly skilled workers are benefitting from further investment in competency building in the work place, there are signs that low-skilled workers in low productivity firms are missing out on skills-building opportunities, getting left even further behind.

Third, policy prescriptions will need to take regional and local circumstances into account. Inequalities that play out in regions, like housing segregation by income or social background, poor public transport and poor infrastructure can lock individuals and firms in low-productivity traps. This means that some policies to promote both productivity and inclusiveness require investments at those levels, particularly in lagging regions.

Fourth, adopting a more holistic approach to policy requires adapting public governance and institutional structure to strengthen the ability of national governments to design policy that promote synergies and deal with trade-offs. Macro-economic policy also has a role to play and monetary and fiscal policies that strengthen aggregate demand, by promoting stronger investment, can increase productivity and household income by boosting job creation and employment. Finally, in highly unequal societies, governments also need to address political economy issues including the capture of the regulatory and political processes by elites that benefit from the status quo, and policies that favour the incumbents.

None of this will be easy, but it is nevertheless essential. Our productivity and inequality challenges are not insurmountable. It is time we took a comprehensive approach to Inclusiveness and Productivity to overcome them. Taking a Nexus approach marks the first step.

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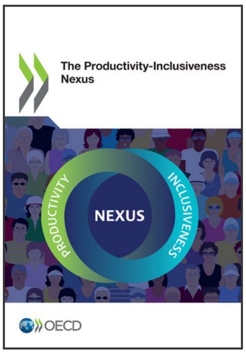

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