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Making Inclusive Growth Happen
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Chapter 4

Mainstreaming inclusive growth into policy making

What can be done about rising inequalities? How can policy programmes be combined to promote more Inclusive Growth that enhances well-being and raises living standards for all citizens? This chapter explores structural policies geared towards both raising the long-term growth potential of economies and making that growth more inclusive. The recommendations laid out pay particular attention to instruments in the following areas: fiscal and monetary policies, labour markets, education, competition and regulation, innovation and entrepreneurship, finance, infrastructure and public services, urbanisation, and development. The chapter sets out to consider how particular policies can be combined to foster synergies, and deal with trade-offs, between growth and equity objectives.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

The previous chapters have shown that, regardless of how it is measured, inequality of incomes is on the rise in most OECD countries, and that it is even higher, on average, in developing countries and emerging economies. Low incomes are associated not only with low material standards of living, but also with poorer health, shorter lives, less education, weaker attachment to the labour market, and lower levels of integration into society at all levels, all of which tend to persist across generations. Despite decades of social policies aimed, with some undeniable success, at narrowing the gaps in outcomes between the disadvantaged and the advantaged, it has become clear that more avenues need to be explored, because high and/or growing inequality pose a threat to both social harmony and to economic growth itself.

Building on the trends described in Chapter 2 and the key elements of the Framework presented in Chapter 3, this chapter discusses the main policy areas that could be part of national Inclusive Growth strategies. Emphasis is placed on the key policy domains that are known to have a strong positive effect on the long-term growth potential of economies and could at the same time lead to improvements in the non-income outcomes that matter for well-being, as well as a better distribution of these income and non-income outcomes. In addition to the focus on outcomes, policy initiatives are also discussed with a view to improving the distribution of opportunities. The major policy areas reviewed in this chapter are macroeconomic (including tax/benefit systems); labour markets; education; competition and regulation; innovation and entrepreneurship; financial sector; infrastructure and public services; national versus regional versus local issues; and foreign aid and development.

4.1. The macroeconomic underpinnings of Inclusive Growth

Sound macroeconomic policies are a pre-condition for sustained growth, employment and poverty alleviation but can also generate some trade-offs between equity and efficiency. A stable macroeconomic framework makes investment less risky, *ex ante*, contributing to sustainable growth and job creation. There is however a trade-off between efficiency and equity in this context: higher investment leads to higher productivity and *higher wages* than would otherwise be the case, but higher investment and capital intensity can also result in *higher income shares* for the owners of capital. Low inflation, which characterises a predictable macroeconomic environment, also encourages investment, which is essential for growth, and preserves the real value of income, which is important for social groups with limited access to financial services and products. Moreover, low budget deficits and government indebtedness are known to create a favourable environment for growth and could make the fiscal policy stance more redistributive by creating room in the budget for higher spending on social services and protection. Macroeconomic policies that prevent a build-up of external imbalances also avoid corrective swings in exchange rates that can be detrimental to vulnerable social groups.

Adverse distributional effects from macroeconomic instability are likely to be strong in developing and emerging market economies. Income losses arising from high inflation are likely to be greater where financial markets are shallower, and many households, especially poorer ones, have no or only limited access to financial services (Prasad, 2013). In those countries, many workers are in the informal sector and have no entitlement to unemployment insurance and formal social safety nets that could cushion the effects of job losses arising from adverse macroeconomic shocks. An economic downturn can thus be financially catastrophic for many households, possibly with long-lasting effects.

Monetary policies and their impact on income distribution

Monetary policy affects the distribution of income. In many countries, monetary policy is conducted within an inflation targeting framework and focuses primarily on price stability. In some cases, central banks also pursue other targets, de facto or de jure, such as financial stability and exchange rate stability, and other indicators, such as the unemployment rate, are being used as intermediate targets where forward guidance is used as part of the monetary authority's toolkit. However, changes in the monetary stance alter the relative prices of financial assets, shifting income between debtors and creditors and the net holders of different financial assets, thus impacting on the overall income distribution.

A stability-oriented monetary policy cushions the impact of negative shocks on poorer households. As noted above, inflation has a direct effect on the distribution of income through changes in the real value of assets. An unexpected increase in inflation hurts savers and benefits borrowers. Inflation hurts in particular richer and older households, as they hold a larger share of their wealth in financial assets, but it is also particularly harmful to the poorest social groups, who tend to hold a larger proportion of their savings in cash. In addition, monetary policy shocks and surprise inflation can have an impact on inequality through their effect on income from labour and on job losses for less-skilled workers. The negative redistributive impacts of monetary policies will be lower where the monetary authorities succeed in countering macroeconomic cycles, rather than overreacting when they do occur.

Nevertheless, macroeconomic stability does not necessarily ensure improvements in the distribution of income. This was the case during the period known as the "great moderation", when economic growth was steady, but income gains accrued disproportionately to richer households, as discussed in Chapter 2. This was because of a combination of factors, not least financial innovation and rising returns to high skills, which favoured the accumulation of income among top earners, at a time when monetary policy focused on the pursuit of consumer price stability and was unable to prevent an asset-price bubble developing.

Monetary policy in developing and emerging market economies often targets the exchange rate in addition to inflation. Efforts to enhance price competitiveness by targeting an undervalued exchange rate tend to favour firms and workers in the tradable sector to the detriment of those operating in non-traded sectors and consumers in general, who pay higher prices for imported goods. Over time, inflationary pressures tend to build up, poorer households are disproportionately hit, and corrective adjustments in the real exchange rate ultimately shift income back to the non-tradable sector. Financial repression, for example through mandated portfolio allocations for banks, may be used to reduce the cost of sterilised interventions in foreign exchange markets (Prasad, 2013).

The effects of capital controls on the distribution of income need to be better understood. In some countries, controls are introduced on capital inflows in periods of abundant international liquidity to raise the relative cost of foreign investment that could be destabilising in shallow capital markets, and would lead to an appreciation of the domestic currency and a build-up of vulnerabilities. Controls are also introduced on capital *outflows* to prevent capital flight in periods of financial vulnerability. Although such controls might work in the short term, they can often be circumvented, making their effectiveness short-lived. More importantly, by altering the relative price of domestic and foreign financial assets, capital controls affect the funding costs of firms differently, often to the detriment of smaller enterprises that cannot easily circumvent the controls and rely on more traditional sources of credit.

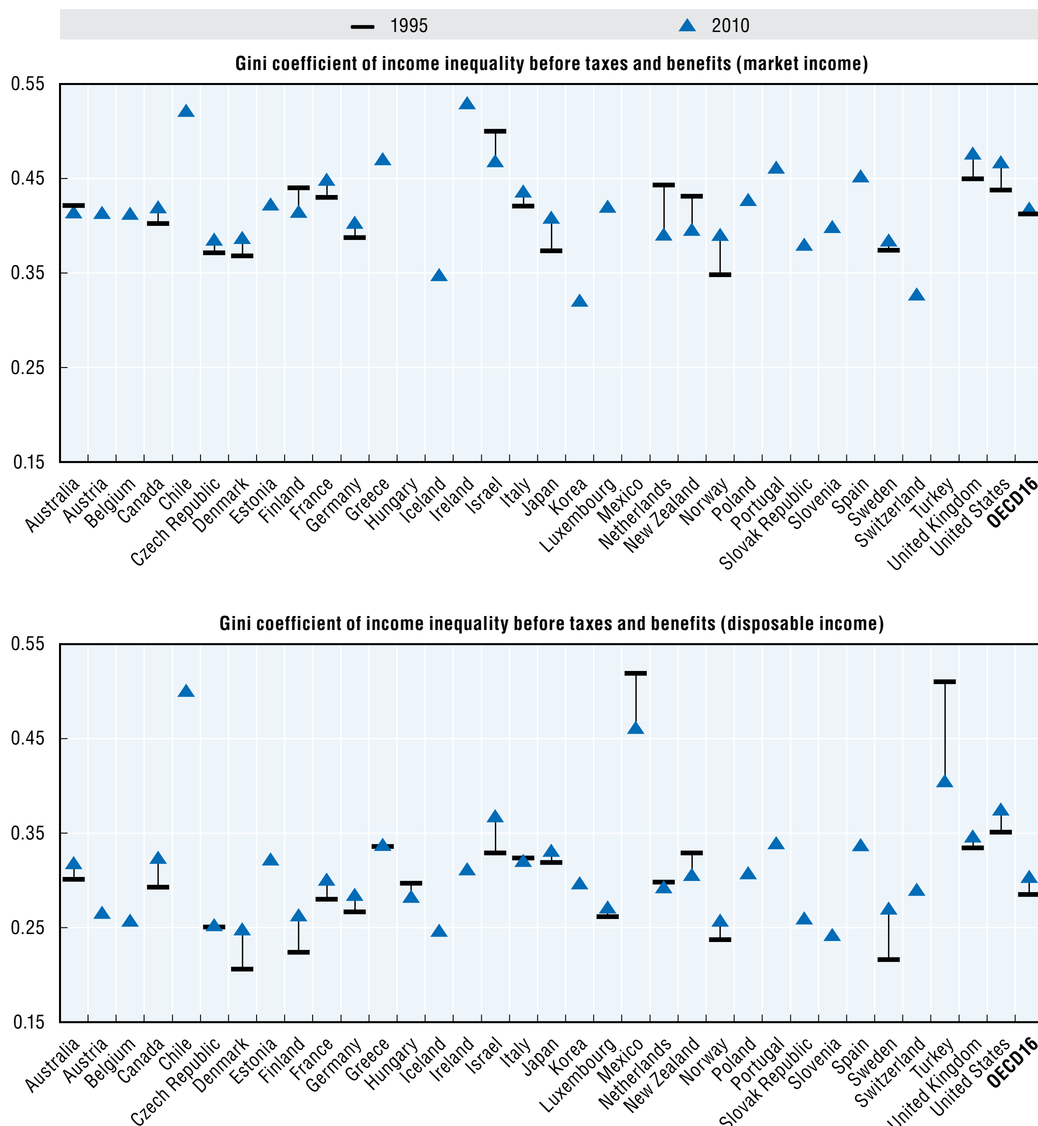
Fiscal policy is relevant to both redistribution and economic stability

Fiscal policy has played a crucial role in mitigating income inequality in advanced economies. This has been achieved essentially through the tax-benefit system, which relies on progressive taxation to finance redistributive transfers to poorer individuals and households, as well as the provision of public goods and services, which creates to varying degrees, depending essentially on programme design and implementation, better opportunities for individuals to participate in economic life. Fiscal policy also plays a crucial role in helping to stabilise the economy over the business cycle, which has a bearing on redistribution, as discussed above.

Although less redistributive than in the past, tax-benefit systems still play an important role in mitigating earnings inequality in OECD countries. In the late 2000s, income inequality among the working-age population was on average 25% lower after taxes and transfers (Figure 4.1) (Joumard, Pisu and Bloch, 2012). The fall in the Gini coefficient before and after taxes and transfers for the whole population is substantial, as much as 0.2 points on average for OECD countries. In practice, about two-thirds of the redistribution has been the result of cash transfers to targeted households in the form of child allowances, public pensions and the like, and one third the result of progressive tax schedules. If in-kind benefits (education, health care and social housing services) are added, the Gini coefficient falls by a further 0.07 points on average for OECD countries (OECD, 2011a). Nevertheless, this substantial equalising effect on net incomes has to be set against a generally rising trend in pre-tax earnings inequality in most OECD countries.

Rising inequality is motivating reform of tax-benefit systems in many countries. In 2013, Greece removed several tax deductions and credits from the personal income tax system, such as for mortgage interest deductibility, and eliminated the tax-free threshold that favours the self-employed (OECD, 2013n). In Indonesia, the government reduced the notoriously regressive fuel subsidy (OECD, 2012f) in June 2013. There is, nevertheless, much room for making tax policy more redistributive and efficient at the same time. For example, in the United States, where the level of income inequalities is among the highest in the OECD, there is a high degree of scope for reducing tax expenditures, which in some cases benefit higher-income individuals and larger firms (OECD, 2012g) (Box 4.1).

Figure 4.1. **Although less redistributive, tax and benefit systems still have a sizeable redistributive impact in OECD countries**



Notes: Data refer to the working-age population. Incomes refer to household equivalised incomes. 1995 refers to 1994 for Greece, United Kingdom and to 1996 for Czech Republic, France, Luxembourg. 2010 refers to 2009 for Japan, New Zealand and Switzerland and to 2011 for Chile.

Source: OECD Income Distribution Database.

Country experiences are instructive. In Colombia, the government introduced a tax reform in 2012 aimed at strengthening the redistributive impact of taxes, promoting formal employment and reducing tax avoidance and evasion. As a result of the reform the poor and middle classes have seen their effective income tax rate fall from 6 to 0%, while a maximum rate finally passed for the richest segment of the population was 15% (the proposal was for 25%) (OECD, 2013m). The 2013 reform of social assistance in Denmark has focused on helping youth with low educational attainment to escape from the inactivity trap (OECD, 2014f). In particular, individuals under the age of 30 are given

financial support to undertake education instead of standard social assistance. In Estonia, the government introduced a means-tested benefit for to help university students from disadvantaged socio-economic background coping with the cost of living while pursuing higher education (OECD, 2012e).

Box 4.1. **Reforming the tax and transfer systems in the US to address rising income inequalities**

Compared with the OECD average, the United States has a significantly higher level of income inequality of over the whole population, and one that has risen faster over time. Whereas real average household market income in the US rose by 34% in the 30 years up to 2009, real median household market income rose by only 14%: indeed, the share of the top quintile increased by 10 percentage points. The inequality of disposable income is now the fourth highest among OECD countries, behind Chile, Mexico and Turkey. After redistribution mechanisms – household taxes and cash transfers – are taken into account, the US also has the fourth highest relative poverty rate among OECD countries, behind Mexico, Israel and Chile. The impact of household taxes on reducing inequality (as measured by the Gini coefficient) is in fact greater than in most OECD countries (the top 1% of tax payers in 2009 paid 22% of federal taxes), but the impact of cash transfers is much lower (Denk et. al. 2013). As in other countries, the distribution of wealth is even more unequal than the distribution of income. It is estimated that the top 1% of households owned 35% of net worth in 2004, and the bottom 40% owned less than 1% (Wolff, 2007). One consequence of the high and rising inequality of both income and wealth, combined with lowered taxes and duties on intergenerational transfers, is that intergenerational social mobility has fallen significantly, and is now lower on several measures than in many European countries (Causa and Johansson, 2009).

The causes of rising inequality are various (Chapter 3), and policies to mitigate it can also vary between countries. In the particular case of the United States, to foster Inclusive Growth, Denk et al. (2013) suggest:

- Direct more resources towards the education of disadvantaged children, and upgrade teachers' salaries to attract more able candidates;
- Raise tax rates on income from capital to discourage the richest households from taking advantage of tax loopholes, without distorting incentives to invest to an unacceptable extent;
- Cap tax expenditure rates on for example mortgage interest deductions or employer-financed health cover to 28%;
- Lower incentives on corporations to move their production abroad to take advantage of lower taxes there;
- Reform social programmes to target the poorest households with means-tested transfers, rather than specific demographic groups.

Protecting the redistributive role of fiscal policies is likely to become more challenging in the years to come. This is because of a number of factors, not least population ageing and the need to maintain fiscal consolidation efforts over the medium term, which will put pressure on national budgets and constrain their ability to redistribute income towards less affluent social groups. At the same time, enhanced mobility across national frontiers for both firms and high-earning individuals continues to put pressure on governments to reduce the tax burden on corporate profits, higher levels of personal income and other mobile tax bases. All of which has made income tax progressively less redistributive, despite international efforts to curb tax evasion, profit shifting and base erosion (Box 4.2).

A full assessment of the distributional effects of consolidation packages would need to consider dynamic measures, such as life-time income distribution and equality of opportunity, along with behavioural responses and interactions with other policies. Increasing direct taxes on incomes would reduce income inequality, while cutting transfers

by the same amount would have a potentially greater and opposite effect. However, raising progressive labour income taxes could have adverse effects on long-run growth, especially in countries where the tax burden on income is already high (Arnold, Brys and Johannsson, 2011). Cuts in government wages and employment can yield fast consolidation gains but need to be accompanied by increases in efficiency of service delivery, for example in the areas of health and education, to avoid reductions in public services hitting vulnerable social groups disproportionately. Cuts in unemployment-related and disability benefits will likely hit poorer people in the first place but may have less adverse effects on inequality in the long run once employment increases in response to a better incentive structure (OECD, 2013f). Those tax expenditures that mainly benefit higher income groups can be reduced, and taxes on immovable property increased. Higher rates of taxes and duties on intergenerational transfers of wealth would not only increase tax revenue, but also make for a more equitable and sustainable distribution of wealth.

Box 4.2. **Combating tax avoidance and evasion**

In an interconnected world, national tax laws have not kept pace with global corporations and fluid capital, leaving gaps that can be exploited by companies who avoid taxation in their home countries by pushing profits abroad to low or no tax jurisdictions. This activity, which is referred to as **base erosion and profit shifting (BEPS)**, undermines the fairness and integrity of tax systems, costs governments money, distorts competition, leads to inefficient allocation of resources, and undermines voluntary compliance by all taxpayers. Because BEPS strategies take advantage of interactions between the tax rules of multiple jurisdictions, only an internationally co-ordinated effort can effectively respond to this issue. At the request of G20 Finance Ministers, in July 2013, the OECD launched an Action Plan on BEPS, identifying 15 specific actions to address this issue in a comprehensive and co-ordinated way, following the core principles of coherence, substance, and transparency. The actions outlined in the plan will be delivered in 2014 and 2015 by the joint OECD/G20 BEPS Project, which involves all OECD members and G20 countries on an equal footing.

Globalisation has also made it easier for all taxpayers to make, hold and manage investments through financial institutions outside of their country of residence. Vast amounts of money are kept offshore and go untaxed to the extent that taxpayers fail to comply with tax obligations in their home jurisdiction. Co-operation between tax administrations is critical in the fight against tax evasion and a key aspect of that co-operation is exchange of information. Responding to a call from the G20 the OECD, working with G20 countries, has developed a single global standard for **automatic exchange of information**. The standard obliges countries and jurisdictions to exchange information obtained from their banks and financial institutions automatically on an annual basis. Further, the OECD is expected to deliver a detailed Commentary on the new standard, as well as technical solutions to implement the actual information exchanges, during a meeting of G20 Finance Ministers in September 2014.

Source: http://oecd.org/tax/beps.htm and *http://oecd.org/ctp/exchange-of-tax-information/automaticexchange.htm*.

Better targeted fiscal policies can improve outcomes for the disadvantaged. Tax policy can help redistribute incomes, and spending on public services, such as health care and education, promotes economic growth and important social outcomes in various ways. But fiscal policies also have a bearing on the distribution on income and

non-income outcomes in other ways, notably by financing social protection systems that help individuals and households cope with disability, unemployment, and inadequate or unhealthy accommodation. Transfers and public spending can increase opportunities for upward social mobility, provide social safety nets, and build a more inclusive social infrastructure.

There is a lot of scope for improving the provision of cost-effective social services in a fiscally sustainable manner in developing countries and emerging market economies. As noted in Chapter 2, inequality of incomes is, in general, considerably higher in emerging market economies than in OECD countries. Informal employment is also widespread, which limits the extent to which governments can rely on progressive taxation to redistribute income and reach the intended beneficiaries of social programmes to improve outcomes along the non-income dimensions that matter for well-being. Taxes on goods and services, customs duties and special taxes on luxury goods play a larger role in those countries than in the OECD area. The deliberate use of fiscal policy to stabilise the economy is limited by the comparatively small size of the public sector and the limited size of automatic stabilisers in the form of unemployment compensation and progressive taxation. On the other hand, as per capita incomes have risen, tax revenues have risen even faster, and there has been more emphasis on social programmes aimed at poorer households, a phenomenon which has been observed in several Latin American countries (Box 4.3).

Box 4.3. **Boosting social programmes in Latin America**

Relative to their GDP, tax revenues are considerably lower for Latin American (LAC) countries than the OECD average: 20% as against 34% in 2010 (OECD, 2014g). Tax bases tend to be narrow and biased towards non-progressive taxes in LAC, where tax evasion is also high. (Gomez Sabaíni et al., 2012) As a result, tax-benefit systems are much less redistributive in LAC than in the OECD area: while the fall in the Gini coefficient before and after taxes and transfers in countries like Poland, Portugal or Spain is nearly 20 points, the reduction in most LAC is below 2 points. Overall, both LAC and OECD countries face the challenge of selecting the tax instruments that are least distortive so as to minimise their adverse growth and employment effects. Consequently, despite significant increases in the past two decades, LAC countries still spend much less in relation to GDP on social programmes, such as education and health care, than OECD countries.

Much has nevertheless been done in several LAC countries to strengthen social protection programmes, including old-age pensions and income transfers to vulnerable households. These programmes have contributed, in different degrees, to alleviating poverty among the targeted population. In particular, unlike old-age pensions, conditional cash transfers have been particularly cost-effective, achieving considerable reductions in inequality at a relatively low cost to the government budget (IPEA, 2012). However, the growth effect of social protection programmes depends on the extent to which they are financed through higher, distortive taxes which create incentives to informality. The issue of how these schemes are financed, e.g. contributions or general tax revenue is crucial in this respect Pension reforms have been central to the social protection agenda in Latin America. Recently, non-contributory pension systems (Bono Solidario, Bolivia) and schemes providing retirement income for informal workers (Beneficios Económicos Periódicos, Colombia) have been introduced. Private pension systems have brought some of the advantages of fully-funded schemes, but limited coverage and low replacement rates persist, which intensifies the incidence of old-age poverty risk.

In developing and emerging economies public finance could play a greater role in redistribution. In many developing countries, low levels of revenue from direct income taxes and limited targeting of public spending reduce countries' capacity to use the tax-benefit system as a powerful redistribute tool, as in mature economies. In Latin America, for example, the average tax-to-GDP ratio is 14 percentage points below the OECD average of 34.6% despite an 8-point rise since 1990. Brazil and Argentina stand out as countries where tax revenues relative to GDP are already close to OECD levels (OECD, 2014g). Because of the existence of large informal sectors it is difficult to raise revenue from personal income tax, and governments tend to rely on revenue from taxes and goods and services (including customs and excise duties) more than in OECD countries. By contrast, income tax revenues in China have risen rapidly from a very low level and could reach 5% of GDP by 2015, mainly reflecting fast growth and under-indexation of the tax schedules, so that a broader array of households are now taxed (Piketty, T and N. Quian, 2009). The example of China, and of OECD countries at earlier stages of their development, underlines the importance of socio-economic policies that foster both economic growth and social advances, notably in education and health care, and favour the rise of a large middle class in the formal sector that accepts the need to share part of the burden of financing transfers to the disadvantaged.

4.2. Revisiting structural policies

Structural policies are at the heart of Inclusive Growth. Structural policies hold the promise to unlock the productive potential of individuals and enterprises in ways that can create more and better rewarded jobs, and generate resources that can be used to help poorer households. Malfunctioning labour markets make it difficult for some socio-economic groups to find and keep good jobs, and this is too often exacerbated by inadequate education and training facilities from early childhood and throughout adult life. Promoting inclusive labour markets and ensuring that workers have the skills necessary to profit from them are thus key elements of the agenda which seeks to combine strong economic growth with greater inclusiveness. Economic growth can also be boosted when firms operate in a competitive environment. But there can be losers as well as winners from structural reforms, which need to be identified when designing policies to cushion vulnerable groups from the adverse effects of reforms.

Promoting inclusive labour markets

Making labour market policies more growth-friendly and pro-inclusiveness requires addressing three main challenges: i) tackling large differences in employment rates across socio-economic groups, with particularly low rates amongst youth, women, older people and low-skilled individuals; ii) reducing persistent in-work poverty, particularly in developing countries and emerging market economies, because of the prevalence of informality, and especially among lone parents and single-earner households with children in OECD countries; and iii) addressing low job quality in terms of insecurity and strain.

To do so, policy makers need to confront a number of important trade-offs. The first is to provide effective social protection systems while at the same time promoting access to productive and rewarding work. A second is to strike a balance between providing the flexibility required by employers and the need to protect workers. A third is to provide levels of wage flexibility that are conducive to strong economic performance and low unemployment, while limiting in-work poverty and the rise in earnings inequality.

Unemployment benefits help to smooth household consumption through periods of unemployment, but can also create disincentives to work. Unemployment benefits help individuals to overcome liquidity constraints while searching for a better job, and therefore play an essential part in any well-functioning labour market (OECD, 2011a). Japan, Korea, Italy and Turkey have sought to expand and extend coverage to all workers as an incentive to higher participation (OECD, 2013o). Chile is set to improve its unemployment benefits system by increasing the average replacement rate as well as the maximum and minimum benefits. However, beyond a certain threshold, generous benefits extended over a long duration and with few conditions, can unduly reduce incentives to work. This why, in some countries, including Belgium, Finland, France, the Netherlands and Portugal, there is a need to reduce duration and replacement rates, and otherwise strengthen job-search incentives, while Spain should strengthen the link between unemployment benefits and active job-search assistance.

Striking an appropriate balance between the need to provide flexibility to employers and the need to protect employees represents a major challenge to policy makers. In countries where employment protection is much stronger for regular jobs than for temporary ones, employers have an incentive to offer temporary contracts, which tend to affect certain groups of workers more adversely. Young workers especially may get trapped into a sequence of temporary jobs and unemployment spells, and have difficulties in fully integrating into the labour market. This tends to increase wage inequality and might not have a durable impact on employment. A reduction in the level of protection of permanent jobs helps to reduce labour market duality, making it easier for vulnerable and less experienced workers to find jobs. Several countries are already working to this end, and reforms have been implemented in the Southern euro-area countries covering different aspects of employment protection legislation, such as a clarification of dismissal criteria in Spain, a decrease in severance pay in Portugal, and the adoption of measures to reduce the cases of forced reinstatement of dismissed workers in Italy. A combination of high flexibility in hiring and firing, as well as high replacement rates together with effective activation policies for the unemployed can help keep unemployment rates low, as in Denmark.

Reducing the legal extension of collective wage agreements might lower labour costs and promote employment, especially for the low-skilled, which is good for growth, but it might also contribute to widening wage distribution. As noted in Chapter 3, a reduction in the coverage of collective-bargaining arrangements has contributed to rising earnings inequality in many countries. Collective bargaining has been amended in Spain to give priority to firm-level wage agreements over sectoral ones. France introduced new legislation "accords de maintien dans l'emploi" ("job safeguarding agreement") in May 2013, which enables employers to negotiate individually with the unions concerning the adjustment of working hours and wages for up to 2 years, in exchange for job security and to reduce potential lay-offs.

Flexible wages allow employers to adjust to temporary and deeper-seated changes in demand, but there are social costs. The challenge is to provide wage flexibility which is consistent not only with good economic performance and low unemployment, but also low in-work poverty and earnings inequality. The example of Germany shows that it is possible to reduce unemployment significantly in a short period of time, but with rising earnings inequality, and calls for the introduction of a minimum wage (Box 4.4). A relatively high standard minimum wage narrows the distribution of labour income, but if it is set too

high, youth and low-skilled workers may be priced out of the labour market. In developing countries, even though minimum wages may encourage informal work, they are often a useful tool against in-work poverty in the formal sector. Moreover, working-time flexibility matters. The experience of the global financial crisis has shown that working-time adjustments significantly contributed to high labour market resilience in countries such as Germany and Japan. This helps to mitigate workers' income losses, while allowing them to maintain their attachment to the labour force and skills, and the firms they work for are better able to survive downturns.

Box 4.4. **Boosting employment through labour market reforms: The German example**

In order to address the challenges presented by stagnating economic growth, high structural unemployment and demographic ageing, Germany embarked on a series of wide-ranging labour market reforms during the period 2002-05 ("the Hartz reforms"). The reforms aimed at strengthening job-search activities for the unemployed, providing job-acceptance incentives, and encouraging labour force participation, particularly among women and older workers. In addition, measures were taken to: reduce the maximum duration of unemployment insurance benefits; close options for early retirement; lower employer social security contributions; and increase the scope for the use of temporary contracts.

The impact of the Hartz reforms on unemployment and labour force participation, along with other factors, has been impressive. After 2005, the harmonised unemployment rate has fell by six percentage points from over 11.3% to 5.5% in 2012, while the labour force participation rate increased by over three percentage points. Consequently, over that seven year period, the employment rate increased by over seven percentage points. These positive trends largely continued during the global financial crisis except for a slight reversal in the first half of 2009. The turnaround in the labour market since 2005 and its high level of resilience during the crisis reflect improved labour market matching and are sometimes dubbed the "German jobs miracle".

However, the German miracle has not been costless: in-work poverty and earnings inequality have both increased. The increase in employment has been to a large extent driven by an increase in marginal employment or work in fixed-term or temporary contracts. The Hartz reforms promoted the use of low-wage low-hours employment contracts by, respectively, increasing the scope of Mini jobs and introducing Midi jobs. Such jobs are either exempt from employer social security contributions or subject to reduced rates. The rise in in-work poverty and earnings inequality led to an intense debate on the appropriateness of a national minimum wage. The current coalition partners have agreed to introduce one as of 2017.

Policies that facilitate access to quality jobs promote growth and reduce inequality simultaneously. Labour market reforms have a bearing on outcomes of several non-income dimensions that matter for Inclusive Growth. For instance, an increase in non-standard employment, such as involuntary part-time or temporary jobs, can lower job quality, in particular for low-skilled workers. It can also increase job strain, adversely impact mental health, and reduce worker capacity to connect to social and professional networks. As a part of a policy programme for increasing job quality, measures to improve employment prospects for youth include effective counselling, job-search assistance and temporary hiring subsidies for low-skilled youth. For instance, Estonia, Ireland and the Slovak Republic

have stepped up their job-search assistance by not only increasing resources but also by streamlining existing measures to increase effectiveness. However, such active labour market policies impose a burden on government budgets, and their effectiveness varies widely across programmes, suggesting that programme design is all-important and that countries can learn a great deal from the experience of others (Martin and Grubb, 2001).

Making work pay and fighting in-work poverty requires implementing targeted policies. Full-time work can be an effective and sustainable way out of poverty, but it does not entirely eliminate the risk of poverty, particularly in developing countries and emerging market economies, or for lone parents and single-earner households with children in OECD countries. Social transfers play a key role, precisely because they can be targeted to the most vulnerable households. In-work benefit schemes, such as the US Earned Income Tax Credit can be particularly effective (Box 4.5). In emerging market economies, conditional cash transfer programmes can provide the most vulnerable with a basic income floor, while ensuring that future generations are better equipped to participate actively in the labour market and find sustainable ways out of poverty by conditioning benefit receipt on children's enrolment in school.

Box 4.5. **Balancing strict eligibility requirements with in-work support: Welfare reform in the United States**

The well-studied 1996 US welfare reform provides substantial evidence on both the employment as well as poverty effects of welfare-to-work packages targeted at recipients of social assistance and similar benefits. It also highlights the trade-offs that characterise the different options faced by policy makers.

The main element of the US reform was to replace the Assistance for Families with Dependent Children (AFDC) with the Temporary Assistance for Needy Families (TANF), which is time-limited and subject to more stringent behavioural requirements. Bringing down the number of benefit recipients was a major objective associated with reforming welfare benefits in a considerable number of US states.

The evidence shows that the earnings and employment of low-income lone parents (the principal target group of the US reform) increased as a result of stepping up welfare-to-work measures, and that some of the positive employment effects can be attributed to a virtuous cycle of declining beneficiary numbers, lower spending on out-of-work benefits, and a resulting increase in funds available for work-related support (Earned Income Tax Credit (EITC) as well as the extended availability of public support for childcare and health insurance). However, because of the more rigorous eligibility requirements for TANF, and the resulting narrowing of the group entitled to benefits, average household incomes rose by less or not at all.

Source: OECD (2013a), *Activation Strategies for Stronger and More Inclusive Labour Markets in G20 Countries: Key Policy Challenges and Good Practices*. Prepared for the G20 Task Force on Employment.

More generally, effective social protection is important for inclusive labour markets. The global economic and financial crisis has shown that effective social protection can prevent individuals and households from becoming trapped in debilitating poverty and empowers workers to seize market opportunities, while acting as an automatic stabiliser at the macroeconomic level (ILO and OECD, 2011). It is fundamental, however, that social protection systems operate in tandem with employment policies by focusing on, for example, social benefits that are employment-related or pension reforms that raise effective

retirement ages and are accompanied by measures to promote the employment of older workers. Child-care related reforms can be particularly effective in allowing parents to remain in or re-enter the workforce. Countries like Australia and the United Kingdom have expanded the provision of early childhood education, while Korea provides subsidies to childcare for all children up to 5 years old, and Germany is significantly increasing childcare places for full-day schooling. Some policies may have short-term costs but potentially attractive future pay-offs. This is the case of active labour market policies, especially for youth, and programmes that help to reconcile work and family life.

In developing countries and emerging market economies, labour market informality delivers flexibility at the expense of inclusiveness. The share of informal employment, even excluding agriculture, is over 50% in several countries (OECD, 2011d and Jütting, 2009). While informality allows low-skilled individuals of working age to earn a living, they are usually employed in poorly paid and precarious jobs, which leads to substantial levels of inequality in earnings. Since informal workers and the firms where they work do not pay taxes, informality shifts the burden of taxes and social security contributions to workers in the formal sector. As a result, in countries with sizeable informal sectors, governments rely more heavily on indirect taxes, and typically limit access to social insurance to workers and their dependents in the formal sector, which undermines economic efficiency and impinges on the distribution of income. The loss of employment for informal sector workers can therefore be catastrophic for both the workers themselves and their families.

Strict employment protection legislation (EPL) discourages formal sector employment in some countries and is therefore a poor social protection instrument. In these circumstances EPL can end up hurting the workers it was meant to protect. High dismissal costs and restrictive severance procedures often discourage job creation in the formal sector, which penalises those vulnerable workers who could otherwise find a job in the formal sector and end up trapped in precarious jobs (OECD, 2013n). A vicious circle of exclusion, duality and low economic growth is therefore created, because firms in the informal sector – often one-man firms, or with few employees, probably family members – tend to have low levels of physical capital and productivity. Informal entrepreneurs might not be particularly skilled and resort to informal activities, because they cannot find jobs in the formal sector (Banerjee and Duflo, 2007). These firms co-exist with large, highly efficient and profitable firms in the formal sector (Bertranou, 2010), which perpetuates duality and exacerbates inequality.

Unemployment insurance schemes face particular challenges in countries with substantial informal employment. Some workers might opt for formal employment if they believe that their risk of unemployment is high, a case of adverse selection, while some workers may find work in the informal sector while receiving unemployment compensation, a case of moral hazard. In Latin America, some governments have reacted to the informal sector challenge by instituting "Unemployment Insurance Savings Accounts", into which workers and employers contribute in periods of employment, and from which withdrawals are made when unemployed (Jütting, J. and J. de Laiglesia, 2009).

Boosting human capital for growth and equity

Education and skills are critical for growth and inclusiveness. Workers' human capital, educational attainment and skills not only determine employment and earnings, but they also matter for health, social participation and overall living standards, which are key non-income dimensions that matter for Inclusive Growth (Chapter 2). The distribution of educational benefits early on determines in part future opportunities and successes, as

well as each person's standing later in life. People's innate abilities differ from birth, but their opportunities to develop their talents through high-quality education and training throughout their lives vary even more, leaving some people at a disadvantage to others.

A transition towards more Inclusive Growth requires ambitious educational and skills policies to reduce inequality of opportunity and outcomes. Measures that improve both growth and inclusiveness include, for example, increasing the quality and extending the provision of education, especially at the pre-primary, upper-secondary and post-secondary levels, raising tertiary educational attainment where upper-secondary attainment is already high, facilitating access to education by underprivileged groups, and expanding vocational and professional education training (VET).

Redistributing educational expenditure over the various stages of the life-cycle is necessary to leverage education's contribution to Inclusive Growth. Educational expenditure per person is typically heavily concentrated at the secondary and tertiary levels, whereas spending on both early childhood education and lifelong learning, where important Inclusive Growth-oriented outcomes can be achieved, is usually much lower on average. Many countries have started to put more resources into pre-school education, but more needs to be done. Equally, lifelong learning, training and skills policies which can remediate or compensate for unequal outcomes of formal education are needed.

An early start to lifelong learning

Effective education policies need to cover a person's whole lifespan, starting with critically important interventions in early childhood education. PISA results show that those school systems that perform the best and provide equitable learning opportunities to all students are also those that provide more inclusive access to pre-primary education. Disadvantaged students tend to have less access to pre-primary education, but some countries manage to avoid this situation. For example, Estonia, Iceland, Hong Kong-China, Japan and Korea, have smaller-than-average gaps in socio-economic background between those students who had attended pre-primary school and those who had not. These gaps are even larger in developing countries and emerging market economies, where enrolment in pre-school programmes is lower than in the OECD area. Reforms are needed in these countries to expand facilities and ensure that they are affordable, identify appropriate ways to link pre-school provision with primary schools, and co-ordinate pre-school activities with wider early-childhood interventions (UNESCO, 2012).

Social, geographic and financial factors complicate access to primary schools. In Colombia, for example, 42% of the children from the poorest households started school one or two years late, compared to only 11% of children from the richest households. Poverty also has an impact on leaving school early. In Uganda in 2006 80% of children from the richest quintile reached grade 6, compared to only 49% of children from the poorest quintile (UNESCO, 2012). Governments can prevent school failure and reduce dropout using two parallel approaches: eliminating system level practices that hinder equity and targeting low performing disadvantaged schools. For instance, reducing the direct and indirect costs of schooling by lowering or abolishing school fees; providing free stationery, uniforms and meals; and reducing the transport costs play an important role in boosting enrolment in developing countries. Gender-sensitive awareness campaigns on the benefits of education, hiring more female teachers, creating a "girl-friendly" school environment, and ensuring safe travel to and from school can help to reduce gender gaps in education in countries where girls are left behind (OECD, 2012b).

Education up to the secondary level is important for finding and keeping good jobs

Raising educational attainment up to at least lower-secondary level is likely to reduce income inequality. Individuals who reach at least the level of secondary school education are more likely to be in employment than their less educated counterparts. However, the impact of educational attainment beyond the secondary level on inequality remains ambiguous. Cross-country evidence suggests that raising the share of individuals with tertiary education in the working-age population leads to greater *earnings* inequality at first but then to lower inequality as the pool of low-skilled workers shrinks and the rates of return on investment in higher education falls (Knight and Sabot, 1983). By contrast, OECD analysis shows that raising the share of workers with upper-secondary education is associated with a decline in earnings inequality (Fournier and Koske, 2012).

Policies can help prevent failure and promote completion of secondary education. Approximately 20% of young adults leave school before finishing upper-secondary education in OECD countries, dramatically increasing their risk of unemployment, poverty and social exclusion. Five recommendations are relevant here:

- Eliminate grade repetition. Alternative strategies to reduce this practice include addressing learning gaps during the school year, introducing automatic promotion or limiting repetition to subjects or modules failed with targeted support, and raising awareness to change the cultural support to repetition.
- Avoid early tracking and defer student selection to upper secondary levels. Early student selection has a negative impact on students assigned to lower tracks and exacerbates inequities without raising average performance.
- Manage school choice to avoid socio-economic segregation. To ensure balance, options include incentives to make disadvantaged students attractive to high-quality schools, school selection mechanisms, and vouchers or tax credits.
- Make funding strategies responsive to the needs of students and schools, to ensure equity and quality across education systems, and to ensure that support goes to the most disadvantaged students and schools.
- Design equivalent upper-secondary education pathways to ensure completion. Policy options include improving the quality of vocational education and training, allowing transitions from academic to vocational studies and removing dead-ends, reinforcing guidance and counselling for students, and designing targeted measures to prevent dropout, such as creating additional pathways to obtain an upper secondary qualification or incentives to stay in school until completion.

Education policies should focus at disadvantaged students and poorly performing schools

There are major benefits for countries which boost the educational attainment and skills of vulnerable social groups, equipping them to compete for better-paying jobs. Cross-country evidence shows that if Turkey, a country with over 40% of 15 year-old students performing under the 400 points benchmark in the 2006 wave of PISA, could bring all low-achievers up to that mark, it would boost its GDP by over 1000% over the lifetime of these children (OECD, 2010d). Improving educational opportunities for the populations most at risk, such as women, migrants and rural youth, could generate progress not only in economic growth, but also in poverty, health and overall development (UNESCO, 2012).

Policies also need to improve low-performing schools and classrooms by offering a quality learning experience for the most disadvantaged. Low-performing schools often lack the capacity or support to improve. Five policy recommendations have shown to be effective:

- Strengthen and support school leadership. To attract and retain competent leaders in these schools, policies need to provide good working conditions, systemic support and incentives.
- Stimulate a supportive school climate and environment for learning. Disadvantaged schools need to focus on prioritising the development of positive teacher-student and peer relationships, as well as the use of data information systems to identify struggling students and the factors of learning disruptions. These schools may also benefit from an alternative organisation of learning time, smaller classrooms and schools.
- Attract, support and retain high-quality teachers by providing targeted teacher education and mentoring to ensure that teachers, including novice teachers, receive the skills and knowledge they need for working in schools with disadvantaged students.
- Ensure effective classroom learning strategies. Schools and teachers should use diagnostic tools, as well as formative and summative assessments to monitor children's progress and ensure they are acquiring a good understanding and a sufficient level of knowledge. Ensuring that schools follow a curriculum promoting a culture of high expectations and success is highly relevant.
- Prioritise the communication link between schools and the communities. Building links with the communities around schools, with both business and social stakeholders, can strengthen schools and their students.

Good initial education provides the necessary learning-to-learn skills to benefit from further skills development opportunities throughout adult life. Lifelong learning is most effectively supported by the development of learning-to-learn skills and transversal skills in initial schooling, and it is further developed during later stages of life. Countries with higher levels of participation in organised adult learning activities demonstrate higher literacy and numeracy skills. The large variation in education among countries at similar levels of economic development suggests major differences in learning cultures, learning opportunities at work and adult-education structures. Policies designed to provide high-quality lifelong opportunities for learning can help to ensure that the adults of the future maintain their skills. Individuals with poor skills, for example foreign-language immigrants, older adults and those from disadvantaged backgrounds, are unlikely to engage in education and training on their own initiative and tend to receive less employer-sponsored training. Second-chance options can offer them a way out of the low-skills/low-income trap. Innovative approaches to community engagement can identify low-skilled adults who require support and provide them with learning opportunities tailored to their needs.

All stakeholders, including governments, employers, employees, parents and students, need to establish effective and equitable arrangements as to who pays for what, when and how. Given the positive expected (private) returns to higher education, introducing tuition fees to make students pay at least part of the cost of tertiary education can lower disposable income inequality measured over the life cycle, especially in countries where income taxation is not very progressive (OECD, 2013f). The introduction of tuition fees in tertiary education may have a negative impact on disadvantaged groups, but these unintended effects can be offset through means-tested grants and income-contingent repayment schemes for student loans.

Developing countries and emerging market economies face specific educational challenges

Developing countries and emerging market economies need to ensure that a high proportion of the population enter education in the first place and do not leave it before they are literate and numerate. Great strides have been made in this respect. In China, for example, school enrolment up to lower-secondary level has risen from 20% to 99% in the post-war period, illiteracy among working-age adults has dropped from 80% to under 4%, and the average number of years already spent in education of those aged 15 years and over is now 9.5 years.[1] Primary school enrolment rates are now similar in most emerging market economies to those in OECD countries, although they remain lower at the secondary and tertiary levels (OECD and ILO, 2011). In some Latin American countries, disadvantaged households are encouraged to enrol and keep young children in education by means of conditional cash transfers.

Policies should facilitate the school-to-work transition, reducing young people's likelihood of being neither in employment nor in education nor training (NEET), especially girls. In developing countries the likelihood to be NEET for girls increases with age and is associated with early marriage and child bearing. Successful school-to-work transition requires integrated, multi-sectoral approaches to education, employment, migration and family programmes policies. High-quality education, better links between the educational and employment sectors, and transparency in labour market information may facilitate the transition to labour market. Discriminatory social institutions, such as laws, social norms and practices that restrict the economic and social roles of girls and women, also play a role in limiting opportunities for women. Promoting gender-sensitive vocational training programmes that are tailored to local contexts, placement and counselling services, as well as discouraging preconceived views about suitable jobs for women will facilitate girls' school-to-work transition.

Competition and product market regulations

Pro-competition reforms in product market regulations promote economic growth, which benefits all households, including the poorest. The pro-growth benefits of enhanced competition in product markets are relatively well known. Regulatory impediments to the entry of firms in product markets deprive societies of the benefits of new products and technologies that lead to productivity gains (Blanchard and Giavazzi, 2003; Nicoletti and Scarpetta, 2005). The improvements in the adoption and diffusion of new technologies that are brought about by competition are at the core of the growth effects of regulatory reforms in product markets. Indeed, the analysis carried out by the OECD and summarised in *Going for Growth*, as well as in the *Regulatory and Competition Reviews* carried out for member and partner countries, quantifies the potential benefits of policy action.

The distributive effects of pro-competition reforms in product markets are somewhat less well understood. Efforts are being made to close this analytical gap, as discussed in Chapter 3, and complement it with evidence-based analysis of the effects of pro-competition reform on different segments of the income distribution and social groups. An important channel, through which distributional effects take place, is the association of stronger competition with greater firm turnover, as poorly performing firms exit the market and more productive ones prosper, which fosters job creation and entrepreneurship. Also, by facilitating entry into product markets, pro-competition reforms result in lower prices, as well as increased availability and/or better quality, of goods and services, which benefit poor households, enhancing their purchasing power.

Vulnerable social groups may end up paying more for goods and services where there is a lack of competition. Indeed, poor and less educated consumers were found to pay more for long distance telephone calls in the United States than wealthier and better educated consumers, even after controlling for differences in usage, a finding that is associated with a lack of competition among service providers (Hausman and Sidak, 2004). Similarly, liberalisation of retail financial markets has resulted in smaller savers having access to bank accounts, where previously they relied on informal credit institutions.[2] An OECD study in Mexico shows that the relative negative effect of monopoly power is greatest among poor households (Urzúa, 2013).[3] Countries such as Mexico and India are opening up some of their network industries to foreign direct investment so as to boost productivity and lower prices. To avoid the risk that multinational enterprises engage in anti-competitive behaviour, which undermine the efficient operation of both domestic and international markets and therefore the positive impact MNEs can make to sustainable development and enduring social progress, the OECD Guidelines for Multinational Enterprises set out government-backed recommendations on responsible business conduct, including protection of consumer interests and competition (Box 4.6).

Box 4.6. **The OECD Multinational Enterprise (MNEs) Guidelines include recommendations directly relating to inclusiveness**

The Guidelines are a set of recommendations on responsible business conduct addressed by governments to MNEs operating in or from adhering countries. They are supported by the representatives of business, worker organisations and non-governmental organisations through the OECD Business and Industry Advisory Committee (BIAC), the OECD Trade Union Advisory Committee (TUAC), and OECD Watch.

There are several recommendations in the MNEs guidelines which are directly related to inclusiveness, including the following:

Enterprises should:

"Encourage local capacity building through close co-operation with the local community" (chapter on General Policies);

"Encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees" (chapter on General Policies);

"Engage with relevant stakeholders in order to provide meaningful opportunities for their views to be taken into account in relation to planning and decision-making for projects or other activities that may significantly impact local communities" (chapter on General Policies);

"When multinational enterprises operate in developing countries, where comparable employers may not exist, provide the best possible wages, benefits and conditions of work, within the framework of government policies" (chapter on Employment and Industrial Relations);

"Be guided throughout their operations by the principle of equality of opportunity and treatment in employment and not discriminate against their workers with respect to employment or occupation on such grounds as race, colour, sex, religion, political opinion, national extraction or social origin, or other status, unless selectivity concerning worker characteristics furthers established governmental policies which specifically promote greater equality of employment opportunity or relates to the inherent requirements of a job" (chapter on Employment and Industrial Relations);

"Take into consideration, in applying the above principles, i) the needs of vulnerable and disadvantaged consumers and ii) the specific challenges that e-commerce may pose for consumers" (chapter on Consumer Interests).

Source: OECD (2011b), *OECD Guidelines for Multinational Enterprises, 2011 Edition*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264115415-en*.

Competition in product markets boosts growth but does not automatically lead to greater inclusiveness (OECD, 2013d). Stronger competition between firms will lead to lower prices and higher productivity, with fewer jobs in some sectors and more in others. Relaxing anti-competitive regulations also tends to reduce the bargaining power of workers,[4] and the loss of a job could be catastrophic for many workers in developing countries and emerging economies. But stronger competition in the production of those goods and services which the poor have a higher propensity to consume, such as basic foodstuffs, health care, housing and transport, could result in an overall improvement in income distribution at the same time as enhancing the economy's growth potential (Box 4.7).[5] The redistributive impact of lowering barriers to entry is likely to be positive in professional services, as the reduction in prices benefit consumers at the expense of a small number of often high-earning incumbents. In sectors where low-skilled labour prevails, such as the retail sector, increased competition may widen the wage distribution, but only insofar as these workers initially benefited from rents. All in all, the impact of regulatory reforms on income dispersion (as opposed to average income levels) has to be examined on a case by case basis, distinguishing carefully between short-term effects from longer-term outcomes (OECD, 2013f).

Box 4.7. **Competition and poor consumers in poorer countries**

There is good evidence that lacklustre competition affects poor consumers in developing and emerging economies. For instance, Peruvian poultry farms and their trade association have conspired to block entry and eliminate competitors. Likewise, 11 Peruvian wheat flour producers and their trade association formed a cartel to end a price war. Zambian poultry firms have demanded that their biggest customer stay out of the production market – and the customer complied. Cartels and boycotting agreements have been discovered and prosecuted in the baking, milling, sugar and milk industries in developing countries. Anti-competitive practices are endemic in public transportation markets such as bus and taxi services, on which many poor consumers depend. The cement industry, on which so much public infrastructure – including public housing – relies, is riddled with cartels and abuse of dominant positions. These problems are not specific to a small group of countries but rather are widespread throughout the developing world.

There are several examples of how greater competition in developing countries and emerging market economies has helped poorer consumers. The advent of mobile telephony, and competition between operators, allows small producers to check on market prices for their output quickly and cheaply, and adjust their schedules accordingly, and mobile telephone-based money transfers for small amounts has allowed poorer people who have no access to normal commercial bank facilities to carry out monetary transactions rapidly and at minimum cost.

Source: OECD (2013d), *Competition and Poverty Reduction*, available at *www.oecd.org/daf/competition/competition-and-poverty-reduction2013.pdf*.

Removing subsidies which distort economic activity promotes competition and can improve resource allocation and equity. There are two general arguments against subsidies. First, the beneficiaries pay less for the good or service than the value to society of the resources used to produce them and, second, they have to be paid for by higher taxes, which can also distort competition. They are also open to abuse when well-financed lobbies put pressure on governments to introduce, retain, or increase subsidies in their sectors, benefitting producers and owners and harming consumers. The end result is that real incomes will be lower than in the absence of subsidies, and the distortion to competition can affect producers and their employees in other countries. In principle, they are acceptable only when they counteract or compensate for a distortion to competition elsewhere.

Removing some sectoral subsidies can however also have a negative social impact when they target or benefit low-income individuals. Despite their drawbacks, virtually all countries have subsidies of some kind, for example those provided to agriculture to aid self-sufficiency, while subsidised education up to a certain level is nearly universal. Subsidies are often targeted at poorer households, by focussing on staple foodstuffs, basic health facilities, and some forms of housing and public transport. Such subsidies are naturally politically popular, genuinely help poorer households and are politically very difficult to remove. If they are removed, flanking policies may be required to aid poorer households. However, in developing countries, the poorest of the poor are often subsistence farmers, who live outside the market economy and do not benefit from such subsidies.

There is a strong case for phasing out or down subsidies that are environmentally harmful. Subsidised fuels and electricity benefit mainly wealthier households that travel in powerful automobiles and heat and cool their large houses. Reforming environmentally harmful subsidies and putting in place prices to fully reflect the resource, investment and operating costs associated with natural resource use, as well as the social costs of pollution or environmental damage, are key policies to support green growth.

There are however trade-offs to phasing out environmentally harmful subsidies. Introducing or increasing environmentally related taxes or charges (e.g. energy taxes, water charges) help to cover the full costs and promote more efficient use of the resource, but can have a regressive impact. To address this, governments often introduce exemptions or subsidised rates for certain uses (e.g. fuels for domestic heating or fishing boats, electricity for irrigation pumping). Universal applications of such exemptions or subsidies often lead to inefficient outcomes that benefit the better off (Box 4.8), and should thus be removed to maintain the price signals of the taxes and charges. Negative social impacts from the

Box 4.8. **Mexico's moves on energy reforms to address environmental and social concerns**

Mexico is making efforts to reform its subsidies to fuel and electricity, while more effectively supporting the poor. In 2008, energy subsidies (1.8% of GDP) in Mexico cost more than twice the amount spent on anti-poverty programmes. Although these subsidies were reduced to 1% of GDP in 2011, they are still highly regressive, with the poorest 20% of the population capturing less than 8% of transport fuel subsidies and only 11% of residential electricity subsidies. Using some of the revenues from reducing energy subsidies to better target support directly to low-income households would benefit the poor, and at a much lower cost to the government budget. Similarly, 90% of agricultural price support in Mexico and 80% of electricity subsidies for irrigation-water pumping benefit the richest 10% of farmers. Overall, Mexico spends more on subsidies to electricity for pumping irrigation water than it does to improve irrigation infrastructure.

The 2013 budget aims to reduce fuel subsidies, and since 2011 irrigation water pumping subsidies in some aquifers have been replaced with direct cash transfers The carbon tax law has just been passed in the Senate in November 2013, although the carbon tax rate is lower than initially planned and natural gas is taxed at zero rate. Nonetheless, this achievement sends a strong international signal about Mexico's commitment to green growth and opens the doors for gradually increasing the carbon tax rate in the future. Efforts have been also made to phase-out energy subsidies. Using some of the revenues from phasing-out energy subsidies to better target support directly to low-income households would benefit the poor and at a much lower cost to the government budget. Conducting a voluntary peer review of its fossil fuel subsidies in the G20 process would further aid Mexico with energy reforms, while addressing social concerns through an exchange of international experiences.

Source: OECD (2013p), *OECD Environmental Performance Reviews: Mexico 2013*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264180109-en.*

reduction or suppression of energy subsidies are better addressed by better targeting compensation measures only for low-income households, or through separate social security systems. Further, a full assessment of the income distributional effects should also include the indirect effects – such as price increases on taxed products, employment effects of using environmental tax revenues, as well as associated environmental benefits.

4.3. Enabling an equity-friendly business environment: Innovation and entrepreneurship

Innovation policies and Inclusive Growth

Innovation is a driver of long-term economic growth and has an effect on the distribution of opportunities and outcomes. Innovation consists by and large of introducing new products and services in the market, or better ways of producing, marketing and distributing them. Innovation is the key driver of productivity enhancement and therefore economic growth over the longer term. However, innovation can also accentuate income disparities if technological change opens up opportunities for individuals holding certain comparatively rare skills to the detriment of those who do not possess them. Moreover, policy settings that impinge on the adoption and diffusion of innovations, such as the regulatory environment in product and capital markets, education and skills, also have a bearing on how individuals benefit from new technologies.

Innovation and innovation policies tend to impact the performance of firms asymmetrically. Particularly in emerging and developing countries, a small group of high performance innovators – "islands of excellence" tend to co-exist with groups of poorly performing firms and an often sizeable informal economy. While the development of high-tech activities is important for economic growth, it is critical to understand to what extent policies also provide sufficient support to a wider group of innovators: they must ensure that the knowledge provided by "islands of excellence" trickle down to the rest of the economy. Framework conditions, such as possibilities for accessing finance or tapping into knowledge networks, are particularly important for the diffusion of new technologies and for "technological followers" to benefit from cutting-edge innovation (Bas and Paunov, 2014). In developing countries and emerging market economies, adaptation of pre-existing technologies to local conditions and use of new-to-the-firm products are important aspects of technological diffusion, which can be enhanced through competition between firms.

Innovation also has a geographical dimension, by affecting the distribution of economic activity and jobs between urban and rural areas or among different neighbourhoods in cities. Typically, innovation activity is concentrated in a few regions, generally advanced metropolitan areas, often close to major universities and research centres, which creates a link between innovation and urban/regional development policy (OECD, 2011c). Because these linkages depend on country-specific conditions and complex policy interactions, more analysis is needed on the geographical dimension of technological diffusion and the effects of innovation on local residents ("*territorial inclusiveness*").

Low-income countries face specific challenges for making innovation the engine of economic development. In some countries, "*inclusive innovation*" initiatives aim at providing poor and lower-income groups with access to innovative products in the areas of food, health and basic livelihood. Many inclusive innovation projects consist of developing business models that could cover at least in part the costs of diffusion of innovations to low-income individuals and small businesses. At the same time, "grassroots innovations",

which are developed *by* the poor, have great potential for creating opportunities for individuals and households to move out of poverty. Grassroots innovations in agriculture are particularly important. A major policy challenge in this area is to create the conditions for these initiatives, which are locally based, to upscale and reach more people: it is often an issue of capacity building and removing market barriers. Success stories such as Kenya's mobile banking service M-PESA, which now reaches an estimated 15 million users, indicate that opportunities for up-scaling exist.

Innovation policies do not necessarily reach their intended beneficiaries. In general, innovation policies are usually designed with no consideration as to their impacts on Inclusive Growth. Tax incentives are conventional instruments to foster innovation, but

Box 4.9. **The digital revolution: Is it good for all?**

The Digital Revolution, including the emergence of the Internet and the fundamental transformations brought about by social media, have encouraged innovation and affected the overall productivity of modern economies. These transformations have, in particular, facilitated better access to knowledge and improved means of communication for a wider group in society, including disadvantaged groups in developing and emerging countries.

The benefits of innovation are traditionally perceived to flow disproportionately to investors in, and managers of, larger technologically sophisticated enterprises (OECD and WB, 2012). No particular skill is needed to operate a basic cell phone, but using ICT as a tool to run a business more efficiently or do research requires an investment of time and money, access to the Internet, a reliable electricity supply, and some literacy and numeracy skills. In consequence, Internet penetration as a percentage of the population in North America, Europe, Latin America, Asia and Africa is around 80%, 60%, 40%, 25% and 14% respectively. Innovation can also accentuate income disparities within countries to the extent that it opens up opportunities for high-skilled individuals and closes them down for the lower and middling-skilled. ICT policies can support Inclusive Growth by helping the development of adequate ICT-based applications that support innovation activities of entrepreneurs and small businesses. A variety of ICT-based applications have brought fundamental changes to disadvantaged groups including also disadvantaged rural communities in developing and emerging countries. They include for instance:

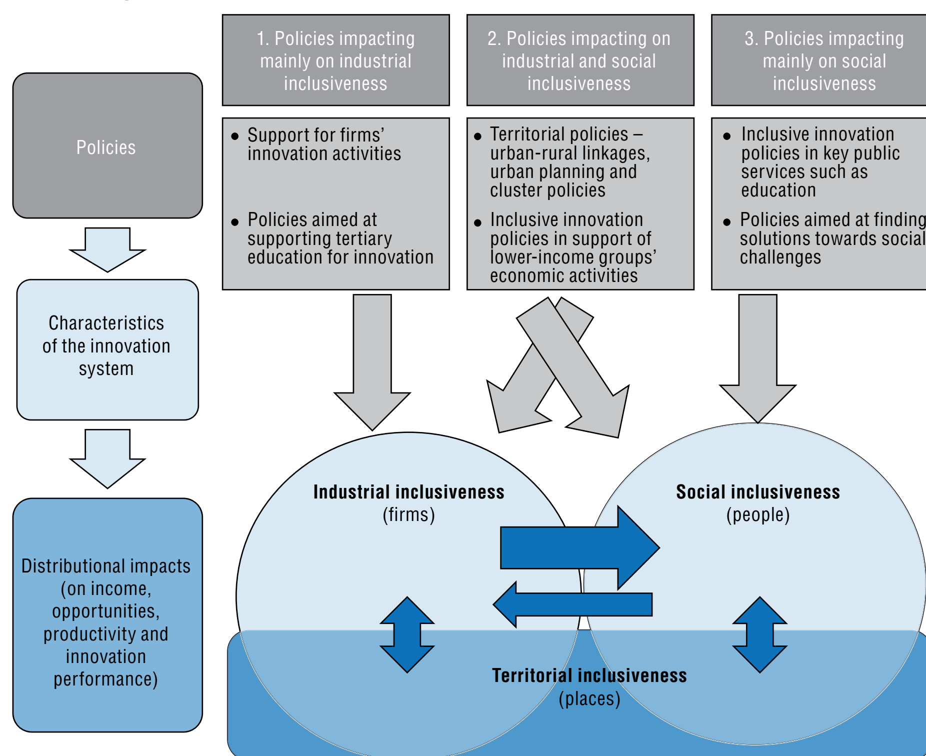
- KACE, Kenya: Provides daily market information on 20 commodity prices, facilitates offers and bids to match farm outputs with demand from wholesalers, and facilitates links between farmers and buyers (e.g. for contract negotiations and commodity transport).
- Farmers Texting Centre, Philippines: Offers an innovative SMS-based service for answering agricultural queries mainly about rice production from farmers, extension workers and other actors. Also provides technological updates on rice production and a virtual network to facilitate interactions among farmers and clients.
- Fisher Friend, India: Provides timely information on local fish markets, weather, the sea, and timely and critical information for fishers. It "also increases their knowledge base by providing information on government schemes and entitlements, health services, directory services, and a marine toll-free helpline". Collaboration between the M.S. Swaminathan Research Foundation (MSSRF), Tata Teleservices in India, Astute Systems Technology, Wireless Reach, and Qualcomm.

At the same time, not only are lower-income groups at a disadvantage with respect to access, they are also likely at a disadvantage for reaping the benefits of ICTs, notably because skills help exploit the opportunities ICTs offer and they are complementary with innovation and technical change. A wider skills base will, therefore, be key to expanding the group of successful innovators.

Source: OECD (2013j), *Innovation and Inclusive Growth*, OECD Publishing, Paris, and Zhenwei Qiang et al. (2011), "Mobile Applications for Agriculture and Rural Development", ICT Sector Unit, World Bank, Washington, DC.

they tend to benefit firms that invest heavily in R&D, and exclude smaller firms and those operating in the informal sector (Figure 4.2). Government grants and subsidies also tend to benefit larger firms and particular sectors or activities, often high-tech ones, at the expense of more basic, lower-tech innovations that might benefit a larger share of the population. It is therefore important to broaden the reach of innovation policies to smaller businesses and entrepreneurs, which often engage in a broader range of knowledge-based activities that go beyond traditional R&D. These innovators also often play a crucial role in the diffusion of new technologies and in adapting them to local needs and conditions. Toner (2011) notes that much of the innovation in OECD countries happens incrementally, where shop floor workers have the discretion and potential to innovate as they 'learn by doing', and companies have the absorption capacity to take these innovations on and mainstream them. In such cases, managers may be more likely to reward a broader section of the workforce as profits rise and product market strategies evolve. Innovation that goes beyond R&D includes changes in institutions.

Figure 4.2. **Impacts of innovation policies on inclusiveness**



There are potential trade-offs between the positive impact of innovation on growth, and the distribution of its benefits. Traditionally, innovation policies focus on the growth impact, but consideration should also be given to supporting innovative activities and products that improve the welfare of low-income groups. Success stories such as Kenya's mobile telephone banking service M-PESA, which now reaches an estimated 15 million users, indicate that opportunities exist. Innovation policies in practice can be exclusive. R&D tax credits, for instance, which focus on firms investing in R&D and, thus, do not support those focusing on other types of innovations. They tend to support larger businesses with R&D departments over smaller ones. A lack of suitable framework conditions also affects small businesses more substantially than larger businesses, and will also hamper "industrial inclusiveness".

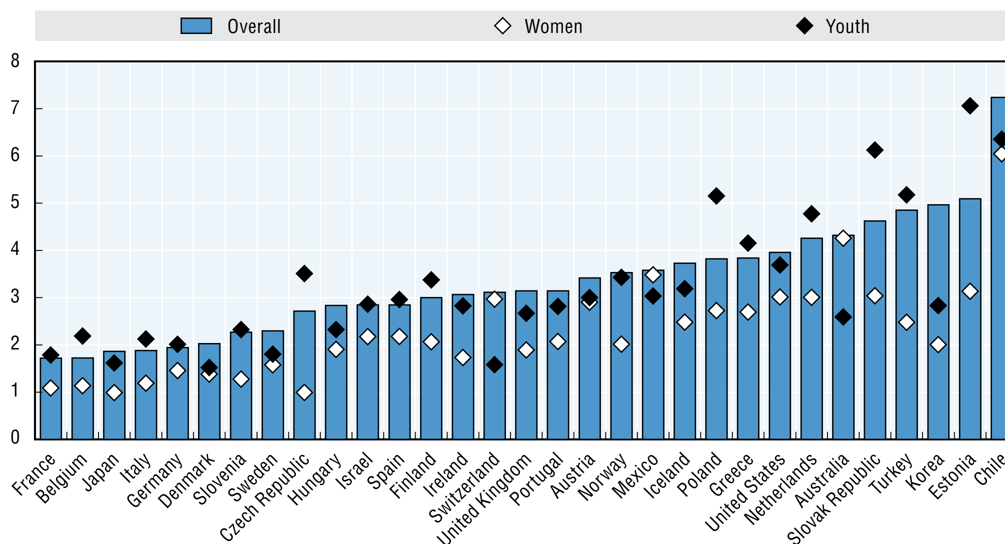
Framework conditions matter for innovation and inclusiveness. With regards to information technologies, addressing "digital divides" is a critical condition for widespread impact. Adequate framework conditions that ensure the Internet is free and open are also essential. Expanding cloud computing services to provide on-demand computing services can also be an effective means to strengthen access for small-scale businesses to a critical input for their innovation performance. Similarly, providing conditions for engaging in innovation processing are critical, including access to finance, skills and other critical "enablers" of innovation.

Entrepreneurship for all

Entrepreneurship is a key conduit for inclusiveness. This is especially the case if disadvantaged social groups have the same opportunities as others to start and operate successful businesses. However, most entrepreneurs are from higher social groups: a study by the Global Entrepreneurship Monitor found that in the United States, a majority of entrepreneurs were male, wealthy, well-educated, white and born in the country (Pressl, 2013). Also, there were only 9 million self-employed women compared with 21 million self-employed men in the European Union in 2013.[6] In OECD countries, most new businesses are owned by men (Figure 4.3). At the same time, there is an entrepreneurship quality gap affecting disadvantaged social groups; indicators of business turnover, income from self-employment and business survival rates are all significantly lower for women, youth and immigrants (European Commission, 2005).

Figure 4.3. **Women in OECD countries have relatively low business start-up rates**

Percent of the population owning a new business between 2008 and 2012



Note: The new business ownership rate refers to the proportion of the population that is currently an owner-manager of a new business that has paid salaries, wages or any other payments to the owners for more than three months, but not more than 42 months.

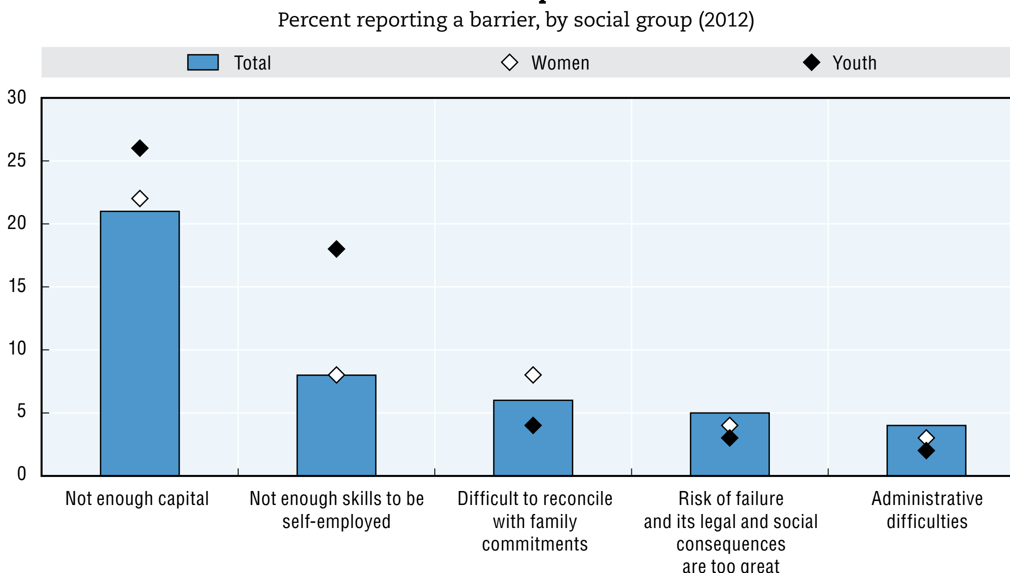
Source: OECD based on data of the 2008-2012 adult population surveys from the Global Entrepreneurship Monitor.

Disadvantaged social groups, such as women, youth and immigrants, face barriers to entrepreneurship. Social norms, networks and welfare systems, as well as access to finance and skills for entrepreneurship, are important obstacles that call for corrective policy action (Figure 4.4). For example, for women, policy action could involve efforts to

make childcare services available to entrepreneurs with young children, build female entrepreneur role models and networks, and adjust social security regimes to offer finance for maternity leave to the self-employed (Pfau-Effinger, 2004 and Achtenhagen and Welter, 2011). For youth, start-up programmes combining finance, coaching and mentoring have proved to be effective.

Figure 4.4. **In the EU, youth and women often face stronger barriers to starting an enterprise**

Percent reporting a barrier, by social group (2012)



Source: European Commission (2012), "Entrepreneurship in the EU and beyond", Flash Eurobarometer 354.

Access to finance and other essential business services are necessary to facilitate inclusive entrepreneurship. Facilitating access to credit for the underserved population, such as small enterprises and the self-employed can do a lot for inclusiveness but also for growth, by removing obstacles to the expansion of businesses and the formalisation of labour relations. Many immigrant groups have to rely on their own sources of finance and typically experience high rates of refusal for bank loans. They also often lack the necessary skills and networks for developing high value-added businesses (Basu, 2006 and APCE, 2002). Even the allocation of credit by non-price mechanisms, such as directed credit, grants and subsidies, often ends up favouring politically connected groups, rather than the underserved population, therefore creating distortions and inefficiencies that are harmful to growth. At the same time, it is important to provide complementary business services focused on advice, coaching and skills development to entrepreneurs and potential entrepreneurs in order to maximise their chances of running successful businesses and contributing to growth.

Entrepreneurship policies should focus on two broad objectives. These include channelling targeted support at the specific problems faced by entrepreneurs from outside the mainstream, especially in the areas of skills and finance, and ensuring that support options are accessible to all segments of the population and not just to the "typical" business or entrepreneur. In particular, key policy recommendations include:

- **Incorporating entrepreneurship support measures for marginalised social groups in active labour market policies**. Schemes such as the Ich-AG ("Me-inc") in Germany have offered monthly allowances to unemployed people who start businesses to help them

cover their living expenses. Evidence shows that 5 years after business start-up 50-60% of former Ich-AG participants were still in full-time or part-time self-employment.

- **Removing disincentives to business start-up in welfare systems, for example by providing child care facilities for those with young children, and helping to finance the transition from unemployment to self-employment**. Spain's Self-Employed Workers' Statute (*Estatuto del Trabajador Autónomo*) came into force in 2007 and aims to give more legal protection to self-employed people and promote equal working conditions for self-employed men and women. The law also introduces provisions for maternity and paternity leave for the self-employed, as well as childcare.
- **Promoting entrepreneurship skills with entrepreneurship education initiatives, targeted advice and coaching initiatives**. For example, the "Going for Growth" project in Ireland provides group support, networking and workshops for women entrepreneurs to boost their entrepreneurship skills and increase their ambitions. A key to the success of this project is the central role that experienced entrepreneurs have in encouraging and teaching participants.
- **Developing microcredit programmes, including through new mechanisms such as crowd funding**. One example is "Seedmatch" in Germany, which is one of the few equity-based platforms in Europe, enabling funders to invest in new start-ups and receive shares in return. Seedmatch carries out an in-depth assessment of the business proposals, which increases the transparency of projects.
- **Facilitating access to credit for small enterprises and the self-employed**. One of the best-known microcredit examples is ADIE in France, which supports businesses started by the unemployed who cannot access traditional financial institutions. It offers loans of up to EUR 6 000 at market interest rates, start-up grants funded by the government or by local authorities and non-interest bearing subordinated loans. These financial products are complemented with business support services.
- **Making mainstream entrepreneurship support accessible and relevant to diverse client groups, using targeted marketing**. An example is Finland's state-owned risk financing company, Finnvera Plc, which offers targeted loans for women entrepreneurs. These loans are derived from mainstream products but are targeted and marketed exclusively to women.
- **Using strong selection criteria to target support at those with the best projects, who are the most likely to succeed**. One example is the Prince's Trust Youth Business Scotland, which supports "un-bankable" young entrepreneurs. The scheme couples targeted business development services and microfinance that is awarded through competitive mechanisms.
- **Accepting that many start-ups will fail, that this is not a policy failure, but that it will require the appropriate modification of policies**. For example, the Start-up Credit for Partially Occupationally Disabled Persons in the Netherlands provides start-up loans for business creation to partially disabled people who can nevertheless participate in some capacity in the labour market. Given the greater difficulties this group faces in the labour market, and the social as well as economic objectives of the policy, the targeted survival and growth rates from these businesses should not necessarily be set as high as for mainstream entrepreneurship programmes and complementary support may be considered. The scheme was recently adjusted to include more coaching following

evaluations of similar schemes in other countries that have highlighted the significant role that can coaching have in successful business start-up.

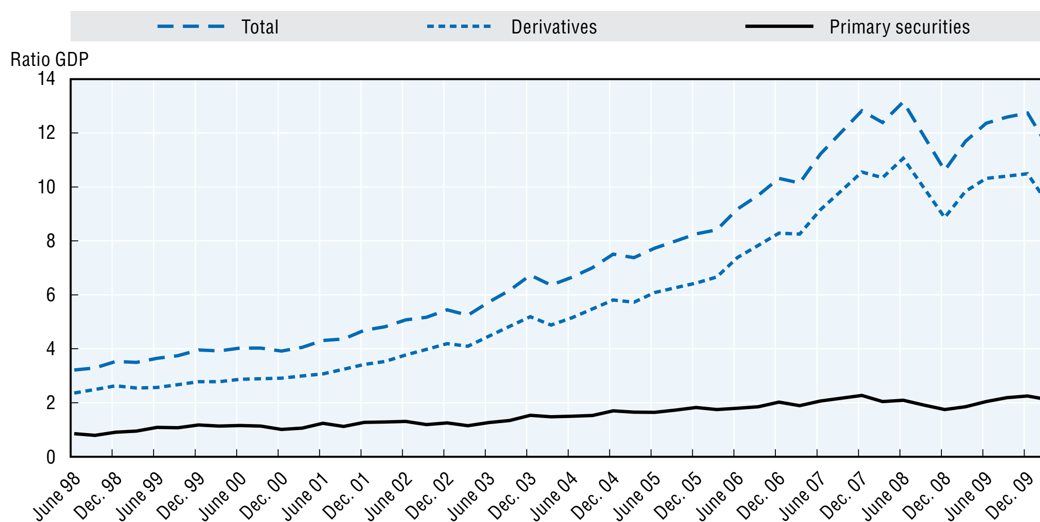
4.4. The financial sector and its relation to Inclusive Growth

Unequal rewards from the operations of the financial markets

Access to finance is central to growth and job creation, but an increasingly complex financial sector puts small savers and investors at a disadvantage. Financial intermediation plays a central role in supporting growth by channelling savings to productive investment, facilitating risk pooling and reducing the cost of capital and investment. However, in their role as financial intermediaries, the financial sectors of OECD countries in particular have moved into trading ever more complex instruments, such as derivatives, on their own account in order to diversify and shift risk (Figure 4.5). Trade in derivatives and other complex financial instruments can be highly profitable, but it requires highly-skilled and highly paid professionals. Computer-based trading strategies have increased short-termism, channelling the rewards mainly to financial market participants (Box 4.10). This increased sophistication of financial markets and products makes individual financial decisions, for instance saving for retirement, more challenging, and more and more financial risks are being transferred onto individuals who are not necessarily well equipped to bear them. It is especially problematic, since pension and health care reforms are making pay-as-you-go public pensions and health support less generous, and defined-benefit private pensions less available.

Figure 4.5. **The growth of derivatives has outpaced traditional financial assets**

Global notional derivatives versus primary securities



Source: OECD calculations based on data from Bank for International Settlements (BIS); Thomson-Reuters, Datastream; World Federation of Stock Exchanges.

The industry of managing household savings has boomed but the benefits of greater financial intermediation have increasingly benefitted the well-off. In many countries, pension systems are increasingly relying on a funded component where the ultimate pension benefits depend on the performance of stock markets. In the last decade pension funds, insurance companies and investment funds have doubled their assets under

management from USD 36 trillion to almost USD 75 trillion.[7] A large portion of these assets is invested in publicly listed stocks. It is estimated that Europeans between the ages of 30-65 today allocate 35% of their savings to the stock market, mostly through funds and other intermediaries (McKinsey Global Institute, 2011). Despite an increased reliance on financial assets among broad segments of the population, an important driver of increased income inequality, as discussed in Chapter 2, is a skewed distribution of capital income. The benefits of greater financial intermediation appear to have gone disproportionately to higher-income households.

Box 4.10. **Short-termism crowds out long-term investment in stock markets to the benefit of traders**

The equity market structure has significantly changed over the last decade. Trade practices have become more sophisticated, markets more fragmented and new instruments have been increasingly dominating the markets. Trading in equity increased much faster than the supply of new equity capital through initial and secondary public offerings in the stock exchanges. Particularly in the pre-crisis period, between 2004 and 2007, the increase in trade volume was three times the increase in new equity capital raised.

An important change in trading practices and investment strategies over the last decade is the dominance of algorithmic trading, which means that orders are executed by computer-based systems according to a pre-designed set of rules and procedures. The current public discussion focuses primarily on one particular type of algorithmic trading, namely high-frequency trading (HFT), which represents the largest, and in many cases an increasing, share in trade volumes in some OECD markets. HFT is characterised by very short timeframes for transactions (e.g. milliseconds) and cancelation of orders shortly after the submission. Today, HFT accounts for more than 60% of the total trading volume in the US equity market. In Europe, it represents some 38% of total trade volume in 2010 with an upward trend.

It is important to note that HFT is more than a technological advancement allowing high-speed computer trading. From a corporate governance perspective, it can also be seen as an investment strategy with a very short-term focus. The goal is not to assess and trade on genuine information concerning the long-term performance of any individual company, but rather to benefit from short-term arbitrage opportunities that are often obtained by unique and fast access to trading information. Defenders of HFT claim that it makes markets more liquid and thus reduces the cost of transactions. Arguably, those cost savings accrue mainly to the HFT traders themselves.

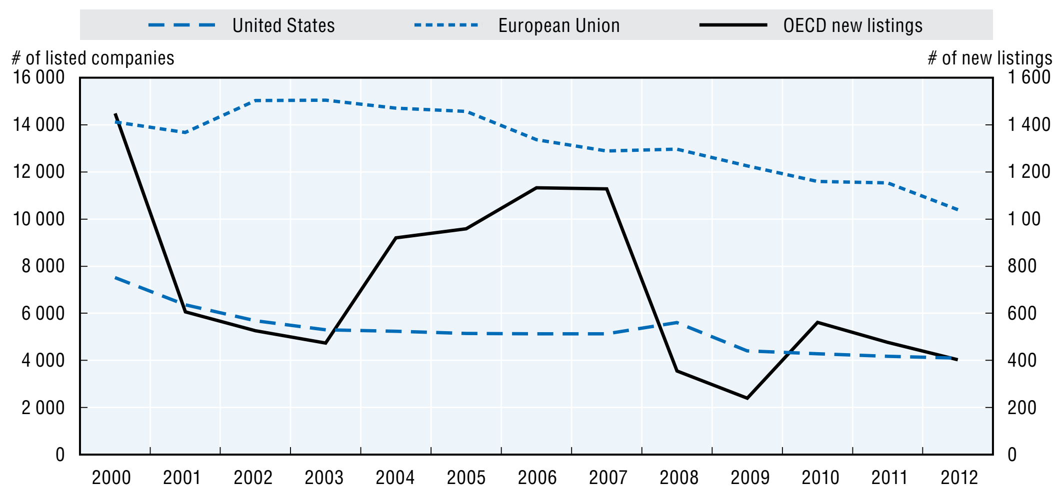
Source: Isaksson and. S. Çelik (2013), "Who Cares? Corporate Governance in Today's Equity Markets", *OECD Corporate Governance Working Papers*, No, 8, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5k47zw5kdnmp-en*.

Companies now finance themselves differently, and their profits are less equally shared. In the last decade, many companies abandoned the public stock markets as a way of raising finance, relying instead on internal funds or raising money on the bond markets via investment banks. There has also been an almost 60% drop in listed new companies in OECD economies (Figure 4.6). Indeed, in the United States the stock market now has only half the number of publicly traded companies that it had ten years ago. At the same time, the number of listed companies in Europe decreased by some 27%. The decision not to be publicly traded is obviously the choice of the individual company or entrepreneur. However, if rules, regulations or tax treatment provide a bias in terms of choice it is a public policy concern, since there are good reasons to believe that the way companies are

financed and managed will affect the distribution in society of the wealth that companies create. When companies become increasingly privately held, the general public is excluded from sharing in their profits and wealth creation.

Figure 4.6. **Companies, old and new, are abandoning the stock markets**

Number of companies listed on stock exchanges and new listings over 2000-2012



Source: Thomson Reuters New Issues Database; World Bank World Development Indicators.

The build-up of debt in the run-up to the global crisis did not benefit poor households. Against a macroeconomic background of low interest rates and rising prosperity, OECD households took on more and more fixed-interest debt, especially mortgage debt. But the value of their assets – real estate and financial assets – was vulnerable to a downturn. The new international rules that regulate banks enabled them to borrow cheaply and invest more riskily. Ever more sophisticated instruments facilitated the creation of debt and were also used to encourage poorer households to take on more debt. This was most prominently the case with subprime mortgages that enabled them to become homeowners, but many were finally unable to service the mortgages. A combination of financial innovation in general, changes in the business models of banks, and the inability of many households to make financial decisions in an environment of increasingly complex financial services and products led to a build-up of debt and growing vulnerability for lower-income, less educated individuals and households.

Rethinking the financial sector

A resumption of credit growth in many OECD countries depends on comprehensive reform of policies and regulations. Comprehensive reform packages include initiatives to strengthen the capital base of banks and make their business models safe by reducing leverage and making risk-weighting of assets less complex and less open to regulatory arbitrage (Blundell-Wignall, Atkinson and Roulet, 2014a). There should also be resolution mechanisms in place for an orderly wind-down of weak banks (Schich and Kim, 2013). But to help prevent bank failures, business model reforms that separate high-risk activities of universal banks (particularly with respect to proprietary activities) should be a priority. Achieving consistency in such business model reforms, already in place or in preparation (US Volcker rule, UK Vickers and EU Liikanen proposals), will be important. Fragmentation of approaches should be avoided, because securities firms operate across national borders and will take advantage of regulatory loopholes. The competitive structure of the banking

sector should also be of policy makers' concern. Empirical evidence indicates the positive role, based on relationship banking, played by smaller banks during the crisis, as they are better able to support households and firms when they go through rough times.

The structure of bank managers' remuneration could be reformed to discourage them from adopting risk strategies that are not socially optimal. Bonuses could be paid in part in assets whose value is tied to that of the parent bank, and some part of large bonuses earned in good years could be made repayable in the case of bank failure. In addition, managers and directors could be obliged to sign affidavits stating that they had checked the risk management systems under their responsibility, and found them satisfactory, thus opening them to lawsuits if risk-taking is found to be excessive (Goodhart, 2013).

It is also desirable to reduce the traditional high reliance of SMEs on bank finance and broaden the range of non-bank financing instruments available to SMEs and entrepreneurs. This would enable them to continue to play their role in Inclusive Growth, innovation and employment. Revitalising securitisation by making it safer, simpler and more transparent is an important element in this effort, and perhaps needs some (initial) government and regulatory support. For mid-sized companies, bonds and private placements may also provide useful alternatives. For high-growth firms, equity finance, including venture capital, is important, and policy can also play a role in supporting seed finance and early stage finance. Many dynamic SMEs might also benefit from equity-type products, in particular "mezzanine finance", a variable mix of equity-type and debt-type financing, normally senior only to common stock. Crowd-funding is another avenue that opens financing possibilities for SMEs. Furthermore, the role of equity markets is important as they allow venture capital companies to be sold to the public in an initial public offering (IPO), and more generally can provide risk capital for mid-cap companies (conventionally companies with a market capitalization of between USD 2-10 billion.[8]

Corporate governance reform is fundamental to the well-functioning of a dynamic private sector and Inclusive Growth. The ability of equity markets to serve the real economy has weakened. This concerns both the primary markets, where growth companies should be able to raise risk capital to innovate, expand and create jobs, as well as the secondary markets where the shares of already listed companies are traded. A decade of far-reaching changes in investment practices, corporate ownership structures and the functioning of stock markets is challenging the conventional wisdom and the relevance of current corporate governance standards. Corporate governance policies should be adapted to better serve the needs of growth companies and those intermediaries who want to take a long-term perspective. Reducing the conflicts of interest and the complexity in the investment chain from households to corporations will provide an opportunity for achieving Inclusive Growth where individual households can share in the wealth created by the corporate sector.

Institutional investors such as pension funds, insurers and sovereign wealth funds, represent a potentially major source of long-term financing for illiquid assets such as infrastructure. Over the last decade, these investors have been looking for new sources of long-term, inflation protected returns. Asset allocation trends observed in recent years show a gradual globalisation of portfolios with an increased interest in emerging markets and diversification into new asset classes. However, the role of institutional investors in long-term financing is constrained not only by the short-termism increasingly pervasive in capital markets but also by structural and policy barriers such as regulatory disincentives, lack of appropriate financing vehicles, limited investment and risk management expertise, transparency, viability issues and a lack of appropriate data and investment benchmarks for

illiquid assets. The matching of long-term liabilities for pension and insurance companies requires sound long-term investments that are suitable for pension funds in terms of viability and duration. Infrastructure investment has the potential to develop financing vehicles that could be well suited to such aims. Developing the right policy frameworks and financial products is therefore a critical and integral part of financial reforms and policy making.

Focusing on individuals and financial consumers

Policies also need to address these problems at the level of individuals and consumers of financial services. Fostering financial education and consumer protection is essential to equipping the most vulnerable groups with the basic skills and competencies they need in order to efficiently use financial services available to them and make informed financial choices as well as to effectively protect these groups against the effects of unfair practices. With a view to consistently addressing these issues, two sets of Principles endorsed by G20 Leaders in 2011 and 2012 respectively were developed on *Financial Consumer Protection* by the OECD dedicated task force and on *National Strategies for Financial Education* by the OECD and its International Network on Financial Education (INFE). These Principles provide a fundamental framework and guidance to design and implement policies to develop consumers' financial awareness and skills while at the same time ensuring that they are adequately informed and protected in their dealings with financial institutions.

Tailored strategies and initiatives based on evidence can be designed to strengthen the population's financial literacy, taking into account individual needs and abilities, as well as the maturity of financial markets. In particular, policies need to target vulnerable groups of the population, such as women, as detailed in the OECD/INFE Policy Guidance (on addressing women and girls' needs for financial education and awareness) and should start early in individuals' lives and preferably in schools to reach out to the population at large (OECD, 2014b and OECD, 2013q).

Developing countries and emerging market economies face their own specific challenges to tackle financial exclusion. Typically, bank branches are in towns, but many of the poor live in rural areas. Poorer workers often work in the informal sector and do not qualify for credit. They also often live in informal settlements and do not have land titles that would allow them to use this capital as collateral against which to apply for a bank loan. The challenge is to make banks more competitive and credit allocation more equitable. In many countries, regulations discourage competition among banks and between banks and other financial intermediaries that could cater to poor individuals and vulnerable social groups, such as credit co-operatives. Subsidised or directed credit, often granted through state-owned banks, also often go to larger or politically well-connected enterprises and benefit wealthier individuals (Levine, 2012). More competition, and reform of public banks, would make banking more attractive for poorer households and lead to a better allocation of household savings.

4.5. Improving access: The role of infrastructure and public services

Equitable access to efficient socio-economic infrastructure and effective public services is essential to achieving Inclusive Growth. Improving access to vital services – including transport, energy, information and communication technology, drinking water, sanitation, irrigation, healthcare and education – contributes to economic growth, and boosts inclusiveness. In mature economies this can take the form of increasing competition in service provision to ensure that consumers pay lower prices, or focusing infrastructure

planning on people's needs. In developing countries and emerging market economies improvements in infrastructure are an integral part of economic development. Access to paved roads, electricity and telecommunication networks allow people to draw higher dividends from their skills, efforts and experiences. At all stages of economic development, enhancing access to infrastructure and public services provides citizens with a means to take advantage of economic opportunity and helps them to live longer, more prosperous and fulfilling lives.

Regulating infrastructure matters for Inclusive Growth

Infrastructure is a public good, but well-designed regulation is needed to avoid excluding potential users. The ability of regulatory reform to boost growth is well known, as is the potential of bad regulation to dampen economic activity. Over the last two decades, experience in OECD countries has highlighted the many costs associated with over regulation. At the general level, constraints in administrative and regulatory capacity reduce the likelihood that regulation will achieve its intended results, and increase the likelihood of unintended costs, which may disproportionately affect certain vulnerable groups. On the other hand, effective regulation can extend access to vital infrastructure to previously underserved segments of the population, bolstering equality of access and contributing to future economic growth. There are three forms of regulatory intervention open to government:

- **Controlling Market Entry:** Relaxing the conditions for market entry can lead to more competitive and effective delivery of infrastructure services. OECD countries have used both horizontal unbundling - i.e. separating an existing electricity enterprise into several generation companies - and vertical unbundling – i.e. separating electricity generation, transmission and distribution activities – to provide new opportunities for competition and market entry.
- **Controlling Prices:** Price regulation is motivated by concerns over abuse by monopolies and the desire to use infrastructure prices to meet various social objectives. However, over the longer term, government attempts to control prices can have negative effects on equity. Regulators need information on utility costs, consumer characteristics and price responsiveness to set appropriate prices, and they need additional institutional capacity to enforce price regulations. Infrastructure prices tend to be politically sensitive, and price regulation has been vulnerable to short-term political considerations leading many OECD countries to rely more on price setting through competition.
- **Controlling Quality:** Regulating service quality based on environmental, safety, health and other considerations can enhance the inclusiveness of infrastructure by ensuring that all population segments have access to higher quality services. In contrast, quality controls can also have the opposite effect, reducing inclusiveness, where the increased costs associated with regulation are passed on to service users. Indeed, in many OECD countries, enhanced competition has required a more dynamic, output-focused approach to the role of quality regulation, for example where regulation of quality is justified, setting standards at the appropriate level has proven to be essential.

Improving access to urban transport

Better transport facilities spur growth and can improve inclusiveness. More efficient[9] transport services facilitate trade and widen the geographical space for competition by reducing the cost of distance, thereby boosting economic growth. This is particularly true

in cities and urban areas. Well-developed, reliable, and accessible urban transport systems mean that workers can seek work further from their homes, making for a better matching of skills and jobs.

There are efficiency and equity trade-offs when implementing new urban transport systems. New above-ground mass-transit systems and urban motorways save time for those who use them. The value of the time saved and the impact on congestion elsewhere in the transport network are the most important factors taken into account when planning and implementing new systems or extensions.[10] Adding to transport infrastructure often means cutting through existing residential areas. This makes it more difficult and costly for residents on one side of the new transport facilities to cross to the other side, and lowers environmental quality for those living close to them. In addition, the time saved by users of the new infrastructure is offset to some extent by the time lost by those inhabitants whose ability to easily access work, school, other activities and amenities has been reduced.

Defining an affordable and accessible network is technically difficult, but essential to Inclusive Growth. Inadequate transport, with long waits and multiple transfers, pushes those with sufficient means into their cars and results in a radical reduction of mobility for the less fortunate. Major conurbations can contain zones within them which are ill-served by public transport, leading to a vicious circle of low property prices, concentrated poverty, lacklustre facilities and people who cannot afford to travel to work by private transport (OECD, 2012h).

Making urban transport more inclusive requires a holistic planning approach. Improving access to urban amenities calls for a drastic rethink of the urban planning paradigm, moving away from concerns about average speeds, travel times and the percentage of driving time spent in congestion. Instead, a new paradigm should focus on citizens' ability to access urban facilities, services and opportunities, such as jobs, public services of various kinds, shopping and leisure. A change in planning paradigm also implies changes in governance and in funding:

- Decisions at the strategic level of urban mobility covering all transport modes should be concentrated in the same political body at the metropolitan level. All modes compete for limited financial resources as well as public space, and the conditions offered to each may have a significant impact on the shares of mobility they represent, as well as their respective contribution to ensuring better access.
- Zoning and planning instructions should always include an explicit study of the ensuing access levels for the future residents or workers, as well as for those in nearby areas, and how that relates to the strategic objectives of access levels.
- Funding of urban mobility must be addressed jointly for all modes of transport, and mobilise resources from direct beneficiaries (the users of the system) and from indirect beneficiaries (those who obtain benefits from the wider access provided by the mobility system). Direct subsidisation of the mobility of citizens with lower economic means or with reduced mobility, including older and disabled people, may be required, but widening the subsidy to all citizens (by lower public transport prices in general) can contribute to a cost escalation that ultimately results in a lower reach of the network and quality of services.

Enhancing equitable access to energy infrastructure

As in the case of transport, adequate and affordable energy infrastructure plays a vital role in ensuring that the benefits of economic growth are more equitably distributed among the population. This is particularly true in developing countries, where "energy poverty", or the lack of access to electricity and clean cooking facilities, is common. Access to modern forms of energy is essential for the provision of clean water, sanitation and health care, and it provides developmental benefits through the provision of reliable and efficient lighting, heating, cooking, mechanical power, transportation and telecommunication services. Almost all the population lacking access to energy infrastructure lives in rural areas of Sub-Saharan Africa and developing Asia. In addition, the World Health Organization estimates that more than 1.45 million people die prematurely each year from household air pollution due to inefficient biomass combustion, a direct result of energy poverty (WHO, 2008) A significant portion of these are young children and women.

Despite real progress made by some emerging market economies in recent decades in providing near-universal access to electricity supplies and clean cooking facilities, the challenge ahead lies in the large scale of investment needed to expand access to energy infrastructure to all citizens. A wide range of policy actions and targeted measures are available to ensure that investment in energy infrastructure boosts economic growth while benefitting the poorest segments of the population. As highlighted in several editions of the *World Energy Outlook* of the International Energy Agency (IEA),[11] all available sources of finance will need to be tapped to target the different segments of the population still lacking energy infrastructure, including international funds, public/private partnerships, bank finance at multilateral, bilateral and local levels and microfinance, loans and targeted subsidies. Public sector intervention will need to take the form of loans and leasing finance to convert unaffordable high initial investment costs into affordable operating costs, grants and even initial operating subsidies. In addition, consumer contributions will be critical to the successful uptake of essential energy services. Evidence suggests that households that pay for even a small fraction of the cost of modern energy services are more likely to provide for maintenance and operating costs.

In mature economies, virtually all households have access to electricity and clean cooking facilities, but some cannot afford to pay for adequate heating. This "fuel poverty" is estimated to affect 9.8% of households in the EU27 and 15.8% of households in the 12 new member states (EU SILC, 2011). It is especially prevalent in former centrally planned economies, where vulnerable groups, such as pensioners and the unemployed, can spend as much as 15% of their total income on energy.[12] In the United States fuel poverty affects about 16 million households, of which only about 1 in 3 receives fuel aid.[13] The main cause of fuel poverty is low household income, but other factors are also important, including the propensity of lower-income households to live in older buildings with poorer heating and insulation standards. Fuel poverty can have severe consequences, a study of 40 000 excess deaths in England and Wales highlighted a potential link between poor housing and poverty and cold-related deaths.[14] Fuel poverty policy in developed economies has focused on two mitigation strategies: i) government or utility subsidy programmes to lower utility or fuel bills,[15] and ii) weatherisation programmes to reduce high energy losses associated with often substandard housing occupied by lower-income households. The latter category of energy efficiency improvements can be particularly effective in reducing fuel poverty, as they permanently lower energy bills for low-income households while saving energy and providing local jobs.

The challenge of delivering an appropriate level of public services in remote areas

Delivering vital services in remote and rural areas can be immensely challenging. The provision of services in these areas carries higher costs to the benefit of a smaller share of the total population. Distances are problematic as transportation and overall costs for the provision of goods and services are higher in rural areas on a per capita basis, and low levels of population and low population density make it hard to achieve a critical mass. Moreover, the aging population structure found in a number of OECD rural areas places additional strain on service delivery. The challenges of providing services in remote areas can contribute to decreased willingness on the part of governments to subsidise rural services, particularly in periods of prolonged fiscal consolidation. In many such areas there is also a severe limitation on the choice of service provider, as there is often insufficient local demand to have numerous providers. This risks creating a situation where providers can "share the market", facing little pressure to compete or to deliver services in a cost-effective manner. There is also the issue of the weaker communication networks found in rural areas where sparseness and distance lead to relatively simple networks with few connections.

The challenge of reaching an adequate level of public service provision in remote areas is formidable, but there are broad policy strategies that can mitigate access problems. Firstly, it is essential to fully exploit synergies by consolidating, co-locating or merging similar services. There is also an increasing role to be played for alternative delivery mechanisms. The Internet will be particularly key in this regard, as it offers the possibility of providing additional services in rural areas, whilst also allowing providers in rural areas to offer services outside their immediate territory. Renewable energy exploitation can also play an important role, by reducing "fuel poverty" which can be a common feature of remote regions. In addition, innovation in remote area service provision is essential to boosting access to existing services, and can encourage the creation of new services in order to achieve better outcomes. The positive effects of service innovation in remote areas have been felt with the creation of services like the mobile handyman enterprise that operates out of a fully equipped vehicle and is scheduled by telephone or Internet.

In developing countries and emerging market economies, the remote rural population is often the poorest of the poor. Some countries, for example China and Brazil, have nevertheless made successful efforts to bring electricity even to remote areas, and to improve access to all-weather roads. But in developing countries in particular, rural subsistence farmers have typically lived outside the market economy, and still have limited access to electricity, paved roads, clean water or basic health services. As noted above, successful efforts are being made in some countries to make grants for services conditional on keeping children in school. Cheaper and more flexible ways of remitting migrants earnings can also help raise their extended families out of poverty. Inclusive Growth in those countries will entail strong efforts to provide better health, transport and educational facilities for those rural populations.

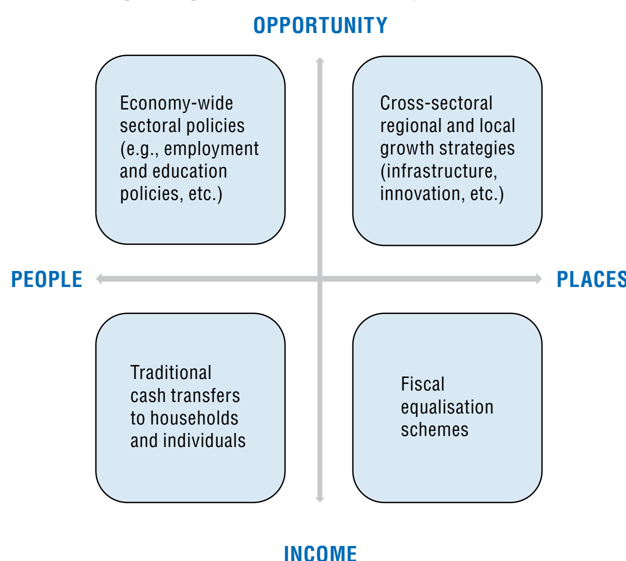
4.6. Acting spatially to foster policy complementarities: Cities matter for Inclusive Growth

Economic and social inequalities have a spatial dimension. As discussed in Chapter 2, income inequality within cities has been rising faster than inequality within countries, essentially due to the skills distribution gap, which is wider in cities. Inequalities among

large regions within a country result mainly from differences in growth rates and the typical policy response is to search for ways of unlocking the untapped growth potential of lagging regions. OECD research points to the potential of a place-based approach to turning around under-performing regional economies (OECD, 2011c and OECD, 2014c). In addition, cities, especially large metropolitan areas, have higher costs of living, particularly because of housing and transport, which lower the purchasing power of low-income groups, forcing them to live in areas with limited access to public transport and job opportunities.

Designing policies to target spatial inequalities requires policy makers to consider the trade-offs and complementarities involved in both the *objectives* they aim to target and the *channels* through which they do so. Addressing income inequalities may encompass both traditional transfers to households – targeting people – and mechanisms aimed at ensuring equity in the provision of public goods and services – targeting places (Figure 4.7). Similarly, policies with the objective of strengthening equal opportunities may be focused directly on households or individuals (economy-wide employment and education policies, for example) or they may involve regional or local development strategies designed to tap the sources of potential growth in specific localities. On average, OECD governments spend about as much on public services with a distinct spatial component as they do on cash benefits and transfers to households.

Figure 4.7. **Targeting inequalities: Objectives and channels**



Purely "people-based" policies – based on personal circumstances and independent of location – can efficiently target resources to poor households, but more is needed to deliver a holistic and sustainable shift towards more Inclusive Growth. In particular:

- **Better access to basic public services**, such as education, health and public safety is fundamental to more Inclusive Growth, and the provision of public services has an intrinsic place-based character. Amenities in cities are rarely distributed evenly, resulting in higher housing prices and rents in areas with good public services, particularly schools. Poor-quality services (especially in education and training) may mean that individuals in

economically distressed places are ill-equipped to pursue opportunities elsewhere or to generate new activities where they are.

- **Mobility** can help address supply and demand mismatches in the labour market, but people may be reluctant or unable to move. Mobility costs include not only transportation and the costs of changing residences but also the possible loss of family links, social networks and other forms of social capital, which are particularly important for people suffering from multiple deprivations. Networks can be important in reducing reliance on services such as child care and elderly care, thus enabling carers – often women – to work.
- **Better design of social housing** can help integrate low-income households in the wider community. Some recent work suggests that not only the quantity and quality but also the *design* of social housing can have a significant effect both on the well-being of residents and on the impact of social housing on surrounding communities. Integration of affordable housing in functioning street networks, for example, appears to be much more promising than the creation of large, physically segregated estates (Box 4.11).

Box 4.11. **Spatial segregation with metropolitan areas**

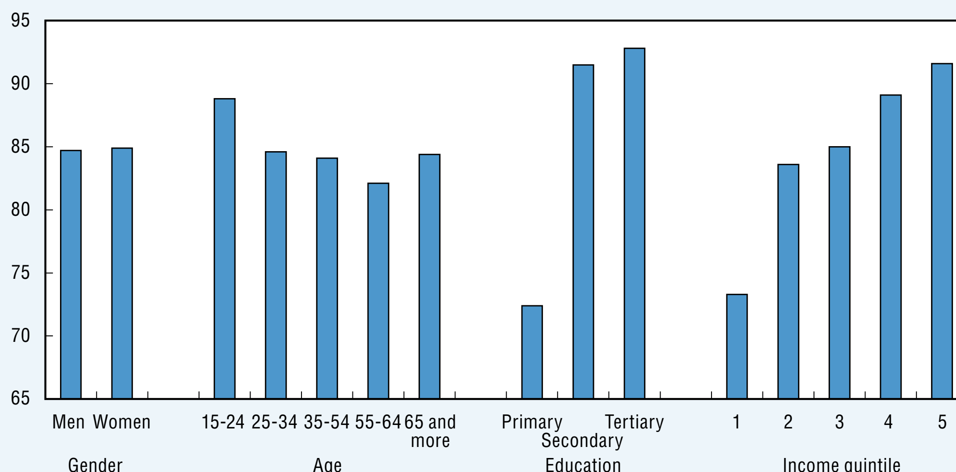
Socio-economic inequality in urban areas is generally associated with strong residential segregation with the low income populations concentrated in disadvantaged neighbourhoods. In developing countries, migration into poor cities from an even poorer rural hinterland has led to the formation of slums. Slums have been almost eradicated in advanced economies but deprived neighbourhoods have become a major issue in many metropolitan areas in advanced economies, including in the wealthiest cities. In many cases, this is also related to social exclusion of certain ethnic minorities. Poor people living in deprived neighbourhoods typically have poor urban amenities and limited access to public transport and other essential public goods and services. Labour market exclusion can become intergenerational, affecting a wide range of factors including health outcomes – a fact recently demonstrated dramatically in a map showing the variation in life expectancies associated with living adjacent to different metro stops in London (James, 2012).

Where more disadvantaged people are concentrated in one place, problems of relative exclusion can be compounded by an absence of positive social networks and low aspirations among the populations. OECD work has shown that social support networks – an important dimension of inclusiveness – tend to be weaker among the most disadvantaged social groups, including the poor and the less educated. A survey conducted by Gallup World Poll found that on average for OECD countries, about 93% of people with tertiary education report having someone to count on, but only about 84% of people with below an 'upper secondary' education have someone to count on (Figure 4.8) (OECD, 2013h). A similar pattern applies between upper and lower income quintiles. While only 73% of respondents in the bottom income quintile report having someone to count on in case of need, the proportion increases progressively with income. On the whole, the residents in distressed neighbourhoods tend to have poorer social networks which can be crucial to employment prospects.

Box 4.11. **Spatial segregation with metropolitan areas** *(cont.)*

Figure 4.8. **In OECD and BRIICS countries, the low educated and the poor have weaker social support**

Number of people (out of 100) who declare that they can count on support from their social network in case of need



Note: Social connections vary substantially across OECD countries. They are measured by the perceived social network support in case of need.

Source: OECD calculations based on Gallup World Poll.

Yet although intra-urban segregation often creates enormous challenges in specific neighbourhoods, neighbourhood-level policy interventions have a mixed track record, at best (see e.g. Cheshire et al. 2008; Mayer et al., 2013; Faggio, 2014). The designation of special zones at the intra-urban scale too easily leads to displacement of activity or to very different treatment of individuals and households whose conditions are in fact quite similar. Thus, while place-based approaches that reflect the conditions of cities are regions are often required, interventions at very small territorial scales need to avoid creating spatial distortions and focus on overcoming spatial segregation via instruments that improve access to opportunity and integrate distressed neighbourhoods into the wider social and economic environment.

The problem of intra-urban spatial segregation is closely linked to that of affordable housing, because many affordable housing policies – particularly the direct public provision of social housing on a large scale – can have the effect of addressing one symptom of exclusion (lack of adequate and affordable housing) while aggravating another (the spatial concentration of the poor). Critics have long tended to link the provision of social housing to the clustering of "social bads" like crime and delinquency in cities, and this has often prompted local resistance to the provision of social housing. However, failure to provide affordable housing can block low-income people out of urban labour markets and cut them off from other urban amenities and opportunities. Fortunately, more nuanced research suggests that better design can help improve both the supply of social housing and its social impact. In many countries, post-war housing estates tended to be designed so that they were, physically, rather inward looking: the aim was to create a sense of community but the result was often to reduce spatial interlinkages with the surrounding city. Moreover, they often created over-complex, and as a result, under-used spaces, which were then populated by, e.g. large groups of unsupervised children and teenagers. This pattern of activity, and the segregation of residents, is not nearly as pronounced in non-estate street networks (Hillier, 2012 and Al Sayed and Hanna, 2013).

Knowledge of local conditions can help policy makers to identify potential synergies among competing objectives and to manage the trade-offs between them that may arise. For example:

- **Policies that improve access to education and training, transport and other essential services** can serve equity objectives, while also supporting growth in a particular place, and they require an understanding of local conditions. For example, policies aimed at improving the supply of affordable housing need to be co-ordinated with transport planning, service provision and labour-market interventions in order to minimise the risk that such policies will result in the creation of ghettoes.
- **Active labour market policies (ALMPs)** can facilitate a better match of jobs with skills, thus lowering unemployment and making a strong contribution to social equality. Yet, ALMPs still need a place-based dimension. Policies concerned with improving information about labour-market conditions, or with improving targets for matching, training or subsidising employers are more effective when designed at the regional or local levels, since information about local conditions is crucial to success (Froy and Giguère, 2010).
- **Green growth policies can contribute to more Inclusive Growth in urban areas**. Some urban green growth policies have much potential for fostering employment and innovation (OECD, 2013g). For instance, integrating land-use, transport and economic development planning can contribute to outcomes that are greener (increasing reliance on public transport), more equitable (improving access to labour markets for disadvantaged areas) and more efficient (reducing congestion, commuting times, etc.).

These issues are even more acute in fast-urbanising middle-income and developing countries. Settlement and urban patterns are still changing fast in those countries, so decisions made today can have lasting consequences. Of particular importance is the strengthening of land rights, which are often informal and poorly protected, and the related question of informal settlements which spring up on the fringes of many such cities, often with undesirable social, economic and even environmental consequences.

Sometimes, though, goals compete with, rather than complement, one another. Cities and regions must recognise and manage the trade-offs that may arise among policy objectives, and effective co-ordination of different sectoral policies is important. It is often impossible for national-level policy makers to predict and manage policy trade-offs; local knowledge is often critical to understanding conflicts that may arise, and thus cities often provide the best setting for successful complementary policies. Unco-ordinated efforts to address inequality and exclusion may lead to poor or even perverse results. For instance:

- **Attracting skilled workers** and increasing the share of knowledge-based activities in urban economies might improve labour markets prospects for the high skilled, but this further increases wage difference between low- and high-skilled workers and drives intra-urban inequality. Urban policy makers should also attempt to upgrade the skills of the local low skilled workforce.
- **Regenerating a neighbourhood** may improve opportunities for business and homeowners, but it may also push up rents and displace the disadvantaged. To ensure affordable housing options for low-income households within rapidly transforming neighbourhoods, housing policies, which are often "people-based", must take the spatial inequality more seriously and co-ordinate with urban development policies.

- New **eco-neighbourhoods** have been open to criticism for an excessively isolated approach (lack of contacts with the existing city) and the effects of gentrification that often go hand-in-hand with their inclusion in the city (Kamal-Chaoui and Plouin, 2012). To ensure that a green growth policy in the building sector contributes to greater social balance, greening policies should focus on social housing, and care should be taken to ensure that energy retrofit projects of neighbourhoods do not penalise residents access to housing.

The "competitive cities" paradigm that prevailed in many places prior to the crisis needs to be rethought. In the past, growth- and competitiveness-oriented urban policies focused above all on the need to create business-friendly conditions to attract footloose investors in a globalising world of mobile capital. While cities clearly need to attract financial and human capital – productive firms and highly skilled people – this paradigm often failed to combine attractive conditions for investment and an improved quality of life in a place.

The competitive cities paradigm may also have often favoured the well-off over the disadvantaged. At the very least, the distributional consequences of growth strategies were given little consideration and in many places there was a tendency (often for political reasons) to favour highly visible investments in physical infrastructure and discrete "development projects" rather than investments in human capital, essential services and quality housing. Policy makers should focus more seriously on integrated strategies for cities, rather than about discrete interventions that address the needs of specific constituencies.

Integrated, place-based approaches also give cities sufficient freedom and flexibility to adopt and implement packages that reflect their particular conditions and needs. Even where policy frameworks are set by national governments (e.g. active labour market policies), cities need the freedom to implement them in ways that reflect local needs and meet local strategic objectives agreed on in partnership. A focus on locally flexible policy-management frameworks would provide local city agencies, including branches of national governments, with a greater say in how interventions are designed, budgets are managed, performance targets are set and activities are outsourced, all within the limits set by accountability requirements (OECD, 2009b, Froy et al., 2011). Initiatives to address skills mismatch, including through training of low income populations and ethnic minorities, can also be better addressed at the urban scale (OECD, 2009a) (Box 4.12).

Greater co-ordination is also required *across* city jurisdictions. Ideally, the provision of public goods should be governed at a high enough level to reduce the disincentives to providing "common goods". Transport and land-use planning, in particular, can result in extremely poor outcomes for both efficiency and equity where co-ordination across jurisdiction is lacking. These issues suggest governing cities as functional economies rather than administrative units. Even relatively modest-sized urban agglomerations are often quite fragmented from a political-administrative perspective. Evidence suggests that leadership from higher levels of government is often required to bring about cross-jurisdictional co-operation among municipalities that is needed in complex metropolitan areas.

Finally, national governments may also need to become better at "city-proofing" their national policies to ensure that they do not have unintended urban effects. National governments could inject more local flexibility in managing active labour market policies

Box 4.12. **Making full use of local skills**

In the **United Kingdom**, larger cities have been awarded "City deals"- agreements with government that give each city an enhanced role in decision making and greater responsibility in deciding how public money should be spent. This has allowed cities to think more innovatively about how they address social and economic exclusion, while also working towards economic growth. The first wave of City Deals were with the 8 largest cities outside of London (Bristol, Birmingham, Nottingham, Manchester, Sheffield, Liverpool, Leeds and Newcastle), and a second wave involves a further 20 cities. Increased flexibility in the implementation of skills policy has allowed Manchester, for example, to set up an Apprenticeships and Skills Hub that has created 2 755 apprenticeships in SMEs.

In Canada, the multi-level Canada-Ontario-Toronto Memorandum of Understanding on Immigration and Settlement creates a partnership with the City of Toronto on immigrant-settlement matters. The MoU outlines tri-level co-operation on key issues related to integrating immigrants into the metropolitan economy and society, including access to housing and other settlement matters, as well as the all-important language-training issue. It establishes a clear framework for full participation by the City of Toronto in the oversight of settlement and language-training programming whose membership was previously restricted to the Province and the federal government.

Also involving Toronto, the Toronto Regional Immigrant Employment Council (TRIEC) was established. It brings together multiple stakeholders – employers, regulatory bodies, professional associations, educators, labour, community groups, government and immigrants. Led by the Toronto chamber of commerce, the TRIEC addresses the issue of how to recognise the skills and credentials of immigrants – who represent a significant and increasing proportion of the working-age population in the Metropolitan Region - in a way that allows them to obtain long-term employment in occupations for which they have been trained. The issue of credential recognition is a key stumbling block in semi- and high-skilled workers' efforts to obtain initial Canadian work experience. Without Canadian work experience, it becomes that much more difficult for an immigrant to enter the Toronto labour force in the field in which s/he has been trained.

TRIEC's work focuses on increasing access to services and programmes that help skilled immigrants effectively enter the local labour market, working with key stakeholders, particularly employers, to build their capacity to work better with skilled immigrants; and working with all levels of government to increase local co-ordination of public policy and programming. This benefits all stakeholders: employers benefit from improved recruitment channels, and access to new distribution; potential employees benefit through building their professional connections and experience through mentoring; educational institutions benefit from help with the development and distribution of learning tools and the curriculum, and finally government benefits through increased support from the private sector and independent interaction between those that supply and those that demand labour force skills. TRIEC relies heavily on the support of mentors within the business community, this can include immigrants who have successfully integrated with the labour force and former "mentees" – graduates of TRIEC's mentorship programme. These mentoring schemes fulfil the dual role of enhancing the networks of new immigrants, whilst at the same time providing them with role models to focus their aspirations.

Sources: OECD (2009a), *Designing Local Skills Strategies*, Local Economic and Employment Development (LEED), OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264066649-en*; OECD (2012), *OECD Territorial Reviews: Skåne, Sweden 2012*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264177741-en*; OECD (2012), *OECD Territorial Reviews: The Chicago Tri-State Metropolitan Area, United States 2012*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264170315-en*; OECD (2014), *Job Creation and Local Economic Development*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264215009-en*; OECD (2006), *From Immigration to Integration: Local Solutions to a Global Challenge*, Local Economic and Employment Development (LEED), OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264028968-en*.

(OECD, 2009b). Local employment agencies can have more discretion in how interventions are designed, budgets are managed, performance targets are set and activities are outsourced, within the limits set by accountability requirements. Research by the *OECD LEED Programme* has shown that when such flexibility is awarded, local employment

agencies become more active partners in city strategies to address unemployment and social exclusion (OECD, 2009b and Froy et al., 2011). Similar incentives are needed in other policy areas, including education and training, housing and immigration. Furthermore, there is a need for more extensive monitoring and evaluation of national and city-level initiatives aimed at fostering Inclusive Growth (OECD, 2013k). There is no clearly-defined "best practice" in this field, and experimentation and innovation are badly needed.

4.7. Adapting development policies faced with poverty and inequality

Structural change and Inclusive Growth

Fast growth of GDP in several non-OECD countries has lifted millions out of poverty, but challenges remain if continued growth is to be more inclusive. The last decade has seen patterns of growth changing across the world, as the centre of economic gravity shifted from Western countries towards the East and the South (OECD, 2010c). This "shifting growth" process, driven by China's rise and integration with the global economy, has directly and indirectly fuelled economic growth in many other countries. Often, these changing patterns of growth have been accompanied by both major increases in productivity and substantial falls in poverty. One of the biggest challenges for policy makers around the world continues to be the identification of strategies that promote economic growth accompanied by continued reduction in poverty and the creation of well-paying jobs for all those who wish to work.

Strong, jobs-rich growth is a necessary step towards Inclusive Growth. This is because employment is still the best means for individuals to boost incomes, and improve material and non-material living standards. Economic development usually entails shifts of labour from a low-productivity agricultural sector and/or low-productivity activities to higher-productivity, more skill-intensive activities in manufacturing and services. In the case of China, most of the very high productivity growth of the last decades has resulted from productivity gains within manufacturing, although labour migration from low to high-productivity sectors has also been significant. By contrast, in India, the two forces were of about equal importance. At the other extreme, within-sector productivity developments in Turkey had a negative impact on overall productivity growth, possibly because higher-skilled workers moved to other sectors where their skills could be put to better use (Figure 4.9).

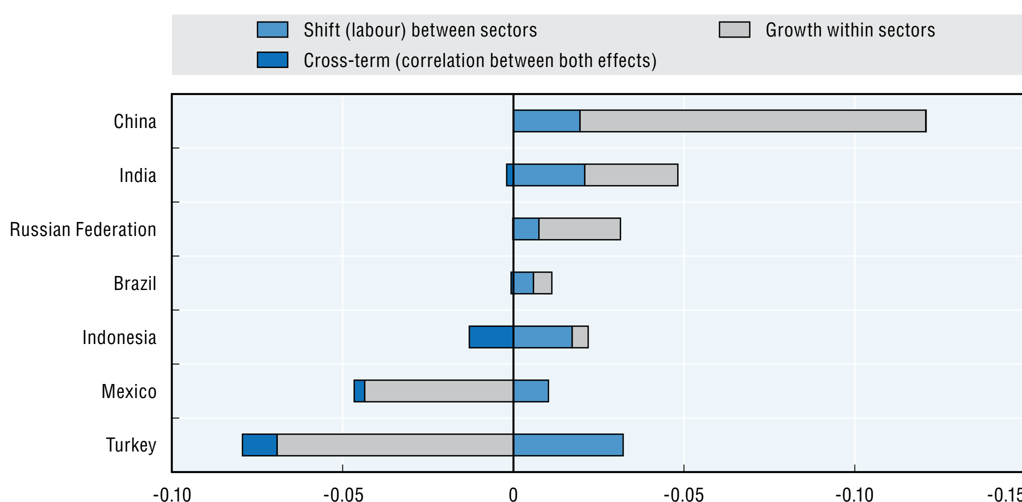
Labour productivity gains through industrialisation can be further enhanced by reaping the demographic dividend. Rising *per capita* incomes in developing countries have typically been accompanied by falling birth rates. When families have fewer children, the number of non-productive dependents falls while the share of those of working age in the population increases. The combined effect from a larger labour force that is employed in more productive activities yields a double dividend. However, if productivity rises faster than demand for the products, perhaps reflecting rigidities in labour and/or product markets, unemployment or underemployment will be the result. Taken together, the benefits of labour shifts and demographic change, as well as the challenges from underemployment, are all linked to the importance of economic (productivity) growth and job creation.

Countries can facilitate structural transformation through policies that boost productivity in low-productivity sectors, and facilitate movement of labour to high-productivity sectors. In the early stages of development a large share of the population is still engaged in low-productivity agricultural activities. Agriculture is still of enormous

importance in most developing countries, the poor are concentrated in rural areas, and most of the extremely poor rely on subsistence farming for their livelihoods. Many developing countries still have significant potential to increase agricultural productivity, for example through mechanisation and investments in more advanced seeds and fertilisers, which can help to free up labour that can then move into other, more productive activities. Smallholder farmers, in particular, face numerous constraints to productivity growth, as discussed above, due to limited access to credit and insurance, as well as land tenure insecurity. Integration of smallholder farmers into vertical value chains can support agricultural productivity. Examples of successful commercialisation of agricultural products are cocoa production in Ghana, or vertically integrated fruit production in Kenya (OECD, 2013b). Typically, the freed-up labour moves first into low-skill labour-intensive manufacturing in urban areas, which calls for the provision of basic infrastructure and other public services, as well as affordable housing, to make the industrialisation-urbanisation process more inclusive.

Figure 4.9. **Shifting labour to more productive sectors spurs growth**

Shift-share decomposition of labour productivity growth, annual average over 2000-2009



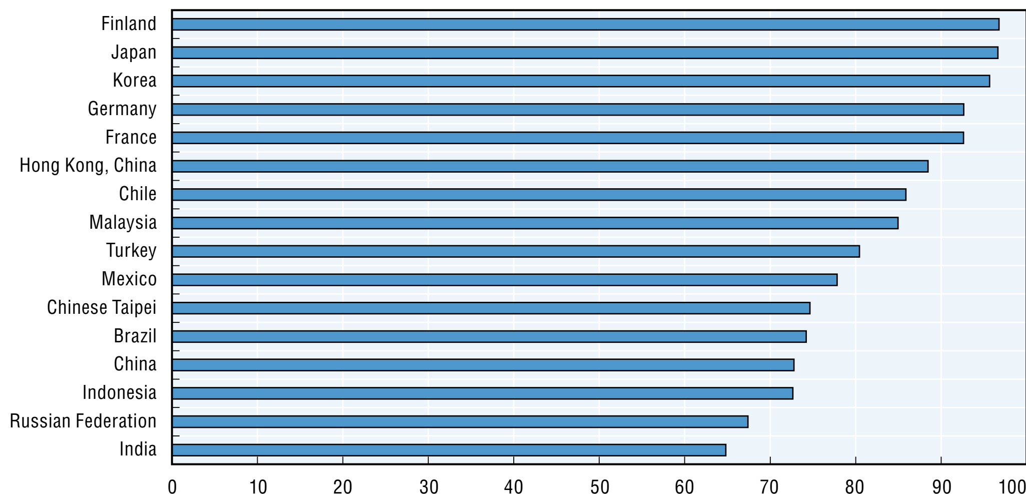
Note: Figure based on 32 sectors including agriculture, mining, 14 manufacturing and 16 service industries in 39 economies. Productivity is measured by value added in 2002 constant US dollars per person employed. The within-sector effect measures the impact of productivity growth within each sector on total economy productivity growth, assuming that sector labour shares are unchanged. The shift effect measures the impact on total economy productivity resulting from the movement of labour between sectors, assuming that the level of productivity in each sector is unchanged. The cross-term effect measures the change in both labour share and productivity in each sector and accounts for the impact of labour re-allocation between sectors with varying productivity growth rates.

Source: OECD calculations using the *World Input-Output Database*.Timmer, M.P (ed.) (2012), "The World Input-Output Database (WIOD): Contents, Sources and Methods", *WIOD Working Paper*, No. 10.

Once the potential of shifting labour out of low-productivity agriculture is exhausted, moving workers from low to high-productivity activities becomes more important. One route is to move up the productivity scale in manufacturing, often by adopting and adapting more sophisticated technologies developed in advanced countries, as discussed above. Relative to the United States, the benchmark country for productivity in manufacturing, emerging market economies still have some way to go (Figure 4.10). As well as involving the creation of new industrial sectors and upgrading of products in existing value chains based on comparative advantage, moving up the productivity ladder also requires strengthening the service sector, which has significant potential to absorb both low and high-skilled labour.

Figure 4.10. **There is still ample room for manufacturing industries in emerging market economies to catch up with productivity levels in the United States**

Manufacturing total factor productivity relative to the United States, weighted average over 2002-09



Note: Average manufacturing TFP 2002-09, weighted by value added in 14 sectors classified according to the International Standard Industrial Classification Revision 3 (ISIC Rev. 3).

Source: OECD's estimations using the United Nations Industrial Development Organization (UNIDO) *Industrial Statistics and the World Input-Output Database*. Timmer, M.P (ed.) (2012), "The World Input-Output Database (WIOD): Contents, Sources and Methods", *WIOD Working Paper*, No. 10.

Policies need to focus on both raising productivity and ensuring that the labour force is equipped to deal with it. Small young firms display stronger productivity growth than old large firms (OECD, 2014a), but new firms, small firms and those in the services-sector often have limited access to finance. New service-sector firms in particular often have limited access to finance. Governments can set up credit guarantee schemes to encourage credit creation and can generally foster entrepreneurship to mitigate the disadvantages of such firms. Governments should also provide targeted education (including vocational and on-the-job training) to prepare for a transition towards higher productivity industrial activities and ICT-based service activities. It is important to provide the right kinds of skills, for example, in many African countries, the university system traditionally focused on providing education for public sector jobs (OECD, 2012a). Adapting educational curricula to market needs is necessary, and governments can support on-the-job training to bridge education mismatches. Developing countries should focus vocational training on sectors and competencies where training would have the strongest employment impact, and establish a clear and widely understood system of skills certification to promote transparency and boost the employability of graduates.

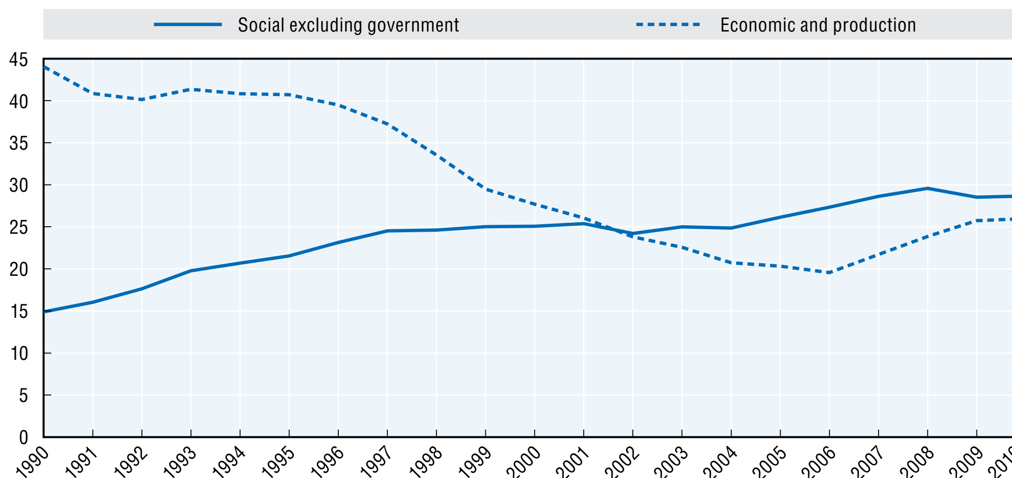
Can development aid support Inclusive Growth?

Aid can support Inclusive Growth by helping to get the enabling conditions right and through targeted interventions, in particular to those living at the fringes of society and in the poorest countries. While the overall empirical correlation between aid and Inclusive Growth is difficult to assess, on balance the cross-country evidence suggests that aid has a positive, albeit small, effect. Inclusive Growth has become a priority in developing country strategies and donors are responding with tailored support in areas such as agriculture, private sector development, health and education. Aid will remain essential, especially in low-income countries, in supporting domestic policies and structural transformation to achieve Inclusive Growth.

The focus of development aid has changed over the decades as lessons are learned and problems facing poorer countries evolve. Since the beginning of the century, the Millennium Development Goals programme helped orient aid towards poverty reduction, health and education, a "pro-poor growth" approach.[16] The experience of the BRICS countries, which had concentrated their development efforts on growth *per se* and lifted many of their citizens out of poverty, encouraged the G20 to call for an agenda fostering "strong, sustainable, inclusive growth" (G20, 2009). The G20 define Inclusive Growth as growth which creates jobs, coupled with social policies and legal protections, involving civil society, NGOs and the private sector. Consequently, and especially since the global crisis, OECD aid donors have started to commit relatively more aid towards economic development, although social aid remains paramount, as has been the case since the beginning of this century (Figure 4.11). In addition, Inclusive Growth objectives will help frame the Post-2015 Development Agenda (Box 4.13).

Figure 4.11. **The share of ODA dedicated to social spending has exceeded that for economic development since 2003**

% total ODA, three-year average commitments



Source: OECD (2013e), *Development Co-operation Report 2013: Ending Poverty*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/dcr-2013-en.*

Aid can help foster Inclusive Growth, but important challenges need to be addressed. Aid helps to support government capacities, address infrastructure deficiencies, and improve education, health care and social protection systems for the poor. These areas are especially important in the poorest, most fragile and conflict-affected states. For such countries, official development assistance (ODA) accounted for over 60% of external financing over the 2005-2010 period (by contrast, for middle income countries, ODA represented a mere 4% (Adugna et al., 2011). Because of the wide variations in aid per inhabitant, the different goals at which aid is aimed, and the comparatively small amounts involved (USD 31.5 per capita per year according to Tarp (2006), it is not easy to quantify the impact of ODA on growth. However, Arndt et al. (2010) finds that ODA equivalent to 1% of GDP raised GDP growth by 0.1% on average over the 1970-2000 period, a small but helpful impact. Clemens et al. (2012) found that increases in aid are usually followed by increases in investment and growth, although the magnitude of this relationship is modest, and it varies greatly across recipients and diminishes at high levels of aid. Similarly, studies on the role of ODA in assisting Inclusive Growth by reducing poverty and promoting health

and education have been positive, but with room for improvement (Collier and Dollar, 2002; Bourgignon and Sundberg, 2007; Virtanen and Ehrenpreis, 2007; Alvi and Senbeta, 2012). Also, Huang and Quibria (2013) find that foreign aid has a positive impact on Inclusive Growth in their sample of countries, especially when aid is directed at the areas of health and education.

Box 4.13. **Addressing Inequalities in the Post-2015 Development Agenda**

The international community, under the leadership of the UN, is currently discussing a new global development agenda. This will focus on a specific set of goals for "poverty eradication and sustainable development" building on the progress already achieved through the Millennium Development Goals (UNGA, 2013).

Today, almost 80% of those living on less than 2 US dollars a day reside in middle-income countries. Despite impressive economic growth in recent years and substantial improvements in health and educational outcomes, growth has been a necessary but not sufficient condition for poverty reduction – growth needs to be more inclusive.

Inequality is also related to sustainability. As mentioned in Chapters 2 and 3, OECD research suggests that increasing inequalities erode social cohesion, stifle upward social mobility, threaten equality of opportunities and generate political instability (OECD, 2011d). Given its prime importance for the future of poverty reduction and sustainability, tackling inequality in its many dimensions (income, political, gender etc.) is crucial for achieving global goals.

There are several areas where aid could make a significant difference in making growth more inclusive. In particular:

- **Expand access of the poor to vital and proven technologies**, such as high-yield seeds, immunisations, modern contraception or Internet connectivity (Sachs, 2005). Easterly (2006) notes that such interventions "give the poorest people the health, nutrition, education, and other inputs that raise the payoffs to their own efforts to better their lives".
- **Identify barriers to growth and take steps to increase the inclusiveness of the growth process**, for example by increasing processing of raw materials and not just their extraction (where this makes economic sense) and by providing infrastructure that helps the poor to access markets (OECD, 2007).
- **Improve the business environment, provide market information and infrastructure while cutting red tape**. The significant risks to doing business in developing countries, especially the fragile and conflict-affected states, can be mitigated via loan guarantees and other debt and equity instruments.
- **In the short term, there remains a need for aid-supported social protection**. Micro-insurance schemes have their uses, although they might not be the most appropriate social protection mechanism for the poor. There have been many positive experiences with Conditional Cash Transfer Programmes (CCTs) on school enrolment rates, reduced school drop-out and improved health and clinic attendance. CCTs are "as close as you can come to magic bullet in development by creating an incentive for families to invest in their own children's futures".[17]

- **Effective democratic governance is a pre-requisite for Inclusive Growth**. Aid that improves government accountability and citizen-state relations can help reduce poverty and support rights, equity and justice, in particular for marginalised populations. Donors can help through technical assistance focusing on electoral processes, the strengthening of legislatures and judiciaries as checks on executive power, and the protection of civil society organisations, including a free press (Knack, 2004).
- **Aid should foster complementary and coherent policies for inclusive and sustainable growth**. Aid can promote renewable energy, low-carbon transportation networks, clean water, waste disposal and sewage treatment, sustainable agriculture and drought-resistant crops; thereby improving economic opportunity, energy access, and public health and sanitation for the poor. Furthermore, aid for capacity building in the areas of eco-system services schemes, environmental fiscal reform and fuel subsidy reform helps meet environmental goals. If savings and revenues are invested in health, education and poverty programmes, environmental and social objectives can be achieved simultaneously.

Notes

1. National Bureau Statistics China.
2. See for example Moreno, L. (2007), "Extending Financial Services to Latin America's Poor", McKinsey Quarterly 83, 90.
3. This study was to some extent inspired by the seminal study from Australia: Creedy J. & Dixon, R. (1998), "The Relative Burden of Monopoly on Households with Different Incomes", 65 Economica.
4. See for instance, Bassanini and Duval, 2006; Griffith et al., 2007; Nicoletti and Scarpetta, 2005; Fiori et al., 2007; Nicoletti et al., 2001.
5. If there is lack of competition all along the supply chain, for example if there is a monopoly importer of a cereal, selling to oligopolistic manufacturers, who sell the final product to duopolistic supermarket chains, imposing competition on only one link in the chain might not make much difference, if any, in retail prices. Attacking all links in the chain might be beyond the resources of the competition policy authorities (OECD, 2013d).
6. Labour Force Survey.
7. *OECD Institutional Investors Database*. *www.oecd-ilibrary.org/finance-and-investment/data/oecd-institutional-investors-statistics/oecd-institutional-investors-statistics_data-00498-en*.
8. *www.investopedia.com/terms/m/mid_cap_fund.asp*.
9. In this context "efficient" means: cheaper, safer, more frequent, with greater carrying capacity, etc.
10. In practice, commuters often react to faster intra-urban transport facilities by moving further from city centres to take advantage of lower land prices and more attractive surroundings.
11. See in particular IEA (2010) special excerpt "Energy Poverty: How to make modern energy access universal" and IEA (2011) special excerpt: Financing access for the poor.
12. Can poor consumers pay for energy and water? An affordability analysis for transition countries, Samuel Fankhauser and Sladjana Tepic, EBRD 2005.
13. "Fuel poverty in the USA: The overview and the outlook", Dr. Meg Power, Reprinted from: Energy Action Issue No. 98, March 2006.
14. Cold Comfort: The Social and Environmental Determinants of Excess Winter Death in England and Wales", Paul Wilkinson, Ben Armstrong, Megan Landon et al. published by The policy Press, UK, 2001.
15. *www.pge.com/myhome/customerservice/financialassistance/*.

16. The OECD DAC Network on Poverty Reduction (POVNET) produced a number of recommendations on how donors could support Inclusive Growth in areas such as agriculture, infrastructure, private sector development, employment generation and social protection (OECD, 2007).

17. Birdsall, N. (2004), in C.W. Dugger, "To help poor be pupils, not wage earners, Brazil pays parents", *New York Times*, 3 January.

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