The Interplay of Inequality and Growth

Remarks by Jason Furman
Chairman, Council of Economic Advisers

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In opening today's important panel discussion, I want to address the interplay between inequality and growth. My comments will draw on a range of research, including the OECD's new report *In it Together*, which is a welcome addition to this organization's long-standing efforts to both document the OECD-wide challenge of increasing inequality and the steps that we can take to address it.

The OECD's work, along with a range of recent theoretical and empirical research in economics, has helped overturn a long-standing belief in economics—that there is an ever-present trade-off between addressing inequality and promoting growth.

The theoretical literature emphasizes a number of channels by which inequality could harm growth: (i) by reducing access to the education necessary for the population to reach its full potential; (ii) by reducing entrepreneurship and risk-taking; (iii) by increasing rent seeking and other unproductive activities; (iv) by undermining the confidence necessary for a decentralized market economy; and (v) by leading to increased political instability, growth-reducing policies, and uncertainty.

Empirically, the relationship between inequality and growth likely depends on the sources of inequality, such as whether inequality stems from greater innovation or from expanded rent seeking. But, the latest cross-country studies make it increasingly untenable to confidently claim that inequality is, on average, good for growth.

The relationship between inequality and growth also depends on the particular policy instruments that are employed—and this is the topic I want to discuss today. I will draw on long-standing OECD work on these issues to discuss three important areas where efforts to address inequality and efforts to promote growth complement one another.

Insufficient Aggregate Demand

I will start with insufficient aggregate demand. The unemployment rate in the OECD today is 7 percent, and 11 percent in the euro area. While these rates have come down, they remain well above pre-crisis levels and well above any reasonable estimate of full employment. They clearly indicate that aggregate demand remains insufficient.

When an economy operates below its full potential, pro-growth policies that help to close the output gap naturally combat inequality. Indeed, unemployment or sub-optimal employment is a form of inequality itself, resulting in zero labor earnings or insufficient labor earnings for a subset of workers. The same macroeconomic policies usually employed to boost growth and return the economy to full employment can unambiguously reduce this cyclical form of income inequality.

Aggressive demand management strategies implemented by the United States can, in this context, also be seen as distributional policies. While fiscal expansion and accommodative monetary policy worked to boost aggregate incomes, their principal goal was the restoration of income to those who found themselves out of work during the crisis.

Moreover, such policies can have long-lasting effects, as many unemployed workers receive lower incomes even after finding a job. The flip side of these potentially long-lasting reductions in earnings is the possibility of long-run scarring in the economy and persistently lower output. That is why continuing to reduce unemployment rates is so important.

The need for such policies was closely aligned across countries in the immediate wake of the crisis. Today, many advanced economies find themselves at different stages of the business cycle. However, as sub-par wage growth manifests itself as a global phenomenon, it is clear that most of the industrialized world remains below full employment, underscoring the continued need for appropriate demand management strategies.

Of course, the quality of capital can be more important than the quantity, and it is critical that public investments be tailored to generate returns through higher productivity. In the United States, we are pursuing a number of such mechanisms, including ending abrupt cuts to budget funding and expanding investments in infrastructure—including President Obama's proposal for a sustained 40 percent increase in critical infrastructure investments.

Economic Rents and Rent-Seeking Behavior

Another area where promoting equality can also promote growth is one that has gathered increased attention in economic policy circles lately: the influence of economic rents and rent seeking behavior. An economic rent is any difference between the income paid to land, labor, or capital and the minimum cost necessary to bring that input into production. Some economic rents can be socially desirable: a consumer surplus is one form of economic rent, as is the monopoly power granted by patent systems to encourage innovation. Other rents such as those extracted from consumers by collusive oligopolies cause distributional challenges without clear productivity benefits. Moreover, when firms and individuals actively invest to capture rents—so-called "rent-seeking behavior"—the capital devoted to this pursuit is unproductive, especially when those investments are made in reshaping public policy to create even more rents and more inefficiency.

Much of the OECD's structural policy agenda works to mitigate the prevalence of undesirable rents and rent-seeking behavior. The focus of the OECD and its Competition Committee on encouraging competition in product markets and discouraging anti-competitive behavior—particularly in the realm of promoting convergence in international antitrust policy—can bring both equality and productivity benefits.

Rent seeking may be a particularly important issue in certain sectors of the economy. Economists have used the concept of rent seeking as a prism to understand the financialization of the economy. This research raises the concern that while finance plays a vital role in channeling capital and sharing risks, absent a sound regulatory regime it can also grow inefficiently large, potentially boosting inequality while even impeding efficiency.

Rents show up in a variety of other areas where policies confer benefits on insiders, like zoning rules that protect existing property owners and requirements for labor credentials to be employed in particular industries. Sometimes there are sound public policy values underlying these judgments, such as certification for physicians. But when they are largely the product of rent-seeking behavior by interested economic actors, they worsen inequality and reduce efficiency.

In many cases, some degree of rents is inevitable, and the challenge we have is that institutional changes have nonetheless made the division of those rents increasingly unequal. This is true in the most fundamental market in our economy: the job market. Consider, for example, a simple job match when a firm decides to hire a given worker. The firm has some maximum wage it would be willing to pay the worker, and the worker has a minimum reservation wage that he would accept. The difference between the two is the surplus created by the job match—an economic rent—but its distribution between the firm and the worker depends upon the wage negotiation, which in turn depends upon which party has the greater bargaining power. Particularly when the firm is a monopolist, its greater bargaining power will tend to extract more rent from lower-wage workers, exacerbating inequality.

Policies like a minimum wage and greater support for collective bargaining can help level the playing field for workers in such negotiations. Because such policies only change the division of rents, they can reduce inequality without necessarily reducing overall welfare. In fact, appropriately tailored, they can foster the previously discussed growth benefits of a better-paid workforce like greater access to education and increased entrepreneurship.

Investing in Families

Economists have long debated whether government programs that support low-income families benefit aggregate growth. But a growing body of economic research has helped confirm not only that these programs can strengthen the position of low-income families, but that they can have important benefits for long-term productivity as well. Indeed, the link between growth and equality is especially apparent at the lower end of the income distribution.

A number of recent academic studies have evaluated the long-term benefits of historical government programs targeted toward low-income families in the United States. One study followed the children of families who received temporary income support from the federal government at the beginning of the twentieth century. Compared with similar children who received no support, the program resulted in higher wages, more education, and lower mortality—with benefits from a few years of income support lasting for 80 years or more. The U.S. Supplemental Nutrition Assistance Program (SNAP)—formerly known as the food stamps program—and our Earned Income Tax Credit (EITC) have been shown to have similar benefits. High-quality preschool programs have also been shown to improve a range of adult outcomes, including reduced crime rates and increased earnings.

Greater education, lower mortality, and lower crime rates do not just benefit the affected individual, but also support productivity and potential growth in the aggregate. When the public sector makes important investments in boosting individual outcomes for the most disadvantaged families, there are clear benefits to aggregate growth. Moreover, in many cases the additional tax revenue associated with this growth may be sufficient to fully recover the initial cost of the programs.

Conclusion

I have emphasized three areas where addressing inequality and growth can be complementary. These are, in a sense, no-brainers from an economic policy perspective. Of course there are other areas where there are trade-offs, and in many cases, these could even be trade-offs that are worth debating.

Ultimately, we care about the incomes of what in the United States we call the middle class and those working to get into the middle class. The key ingredients of middle-class incomes are the overall productivity growth of the economy, the degree to which that productivity growth is shared, and the ability of people to participate in the workforce. President Obama’s economic agenda, which he terms “middle class economics,” is designed to strengthen all three of these elements. I look forward to continuing my partnership with all of you as we work together to promote growth for the middle class—including with approaches that promote equality and growth in tandem.