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Inclusive Growth or Else

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The decision to place inequality at the center of the discussion at Davos this year was a promising development. But actual solutions remain undeveloped, and concern about widening economic disparities within many countries remains inadequate, which must change if the current global economic recovery is to continue.

LONDON/WASHINGTON, DC – At this year's World Economic Forum meeting in Davos, Switzerland, participants did not question the basic building blocks of growth in today's global economy: free markets, good governance, and investment in human capital and infrastructure. But they did criticize how unfairly the benefits of growth are being distributed. Rightly so: without a strong policy response aimed at building a more inclusive growth model, rising populism and economic nationalism will impair the functioning of markets and overall macroeconomic stability – potentially cutting short the current global recovery.

Virtually every economic policy has an impact on both aggregate income and its distribution. Some reforms – such as those promoting impartiality and efficiency of legal institutions – are good for growth and equity (in this case, equality of opportunity). Incidence results for deregulation of product and labor markets are more mixed, possibly as a result of data limitations and the specific circumstances of each reform.

By contrast, when it comes to financial deregulation and the liberalization of international capital flows, there are clear equity-efficiency tradeoffs: they boost growth, but they also tend to increase inequality. The evidence points in a similar direction for some measures aimed at liberalizing current-account transactions (trade in goods and services).

These findings should not come as a surprise: it is well-known that rapid technological change and globalization have contributed immensely to the creation of a winner-take-all economy, in which those with a first-mover advantage accrue a disproportionate share of the benefits of growth.

Policymakers' task is to ensure that the disadvantaged also have opportunities to succeed in the modern economy, by designing all reforms and other measures with an eye to their distributional effects. Otherwise, pro-growth reforms will lose political legitimacy, enabling destructive nationalist, nativist, and protectionist forces to continue to gain traction and thus to undermine medium- and longer-term growth.

The key to success will be to take preemptive action, rather than focusing solely (or even primarily) on ameliorative measures. This means designing coherent policy packages that

internalize the distributional effects of supply-enhancing policies, and that aim to create a better balance of winners and losers across those policies. In our work for the World Economic Forum's Global Future Council on Economic Progress, we have produced a list of concrete actions that would advance such an agenda.
The first critical area of focus is skills training, skills upgrading, and addressing job displacement. Globalization and the so-called Fourth Industrial Revolution have increased the pace of change in labor markets, putting a premium on adaptability. Public policies have a role to play not only in providing a cushion for workers in transition, via income support, but also in creating incentives and opportunities for skills acquisition.

To this end, governments should boost investment in life-long learning to retrain, retool, and reskill. For example, governments could use individual skill accounts to provide training grants throughout people's working lives, conditional on stronger private-sector involvement in training and skills development. Governments should also reinforce the supply of skills by strengthening incentives for educational institutions to harness the power of digital technology and new business models.

A second critical area is taxation and social protection. While the specific policies would vary according to national social contracts, our work suggests that redistribution – unless extreme – does not bring salient efficiency losses. Moreover, the greater equity it brings serves to make economic growth more sustainable, such as by reducing systemic fragilities that can lead to sharp downturns.

When it comes to taxes, it is critical to safeguard the growth model's political legitimacy by ensuring that the system is not skewed in favor of the wealthy. Beyond increased taxation of rents and estates, policymakers should pursue cooperative efforts to stem corporate tax avoidance, tax inversions, and the use of tax shelters. Fiscal transfers should also be better targeted, in order to protect the most vulnerable groups.

Similarly – and this is the third critical reform priority – more aggressive action is needed to regulate financial markets, especially to prevent insider trading and money laundering, and to close down illegal financial centers. Cross-border regulations and measures are also needed to ensure that risk-takers bear an appropriately high cost for recklessness. More generally, countries need to avail themselves of the tools at their disposal to manage cross-border capital flows, with the objective of mitigating the risk of financial crises and their associated fiscal costs.

The fourth and final priority is a more concerted effort to ensure fair competition and avoid crony capitalism. Guaranteeing a level national playing field and a rules-based international order requires effective competition policies and enforcement of fair-trade rules. Whether in industry, services, or the media, anti-trust actions to avoid capture of institutions or industries – by the powerful or the state – are vital to support inclusiveness.

The backlash against globalization – and, in some cases, against capitalism itself – demands economic policies that not only address problematic distributional effects, but also preempt

them. This will require a fundamental change in mindset, with businesses and governments alike recognizing, at long last, that growth can be sustainable only if its benefits are broadly shared.

The decision to place inequality at the center of the discussion at Davos this year was a promising development. But actual solutions remain undeveloped. Despite expressions of anguish about widening economic disparities within many countries, policies to address them remain inadequate. This must change if the current economic recovery – the source of so much relief and hope around the globe – is to continue.

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