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Inequality and growth, the road ahead

Setting up a Voluntary Solidarity Fund

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Introduction

"One needs not be altruistic to support policies that will improve the income of poor and middle classes. Everyone will win because these policies are essential to make possible a more vigorous, supportive and sustainable economic growth" (Lagarde, 2015). This is how Christine Lagarde, in her speech during *les Grandes Conférences Catholiques* 17 June 2015 in Brussels, addressed the issue of rising inequality. Inequality has become a phenomenon of widespread concern as it has increased within most advanced, emerging and developing countries. It has recently received considerable attention from academics, politicians and economists. President Obama called widening income inequality the "defining challenge of our time" (Obama, 2013).

On an annual basis, the World Economic Forum asks its members to identify the issues that in their opinion will have the largest impact on the world over the next 12 to 18 months. Worsening income inequality is at the top of the list for 2015-2016. As the world's wealthiest continue to accumulate wealth at record rates, the middle class is struggling. Over the last 25 years, the average income of the top 0.1% in the U.S. has grown 20 times compared to that of the average citizen (World Economic Forum, 2015.)

In advanced economies, the gap between the rich and poor is at its highest level in decades. Inequality trends have been more mixed in emerging markets and developing countries. Although a few countries experienced declining inequality, pervasive inequities in access to education, health care, and finance remain. Not surprisingly then, the extent of inequality, its drivers, and the possible measures to reduce it have become some of the most debated issues by policymakers and researchers alike.

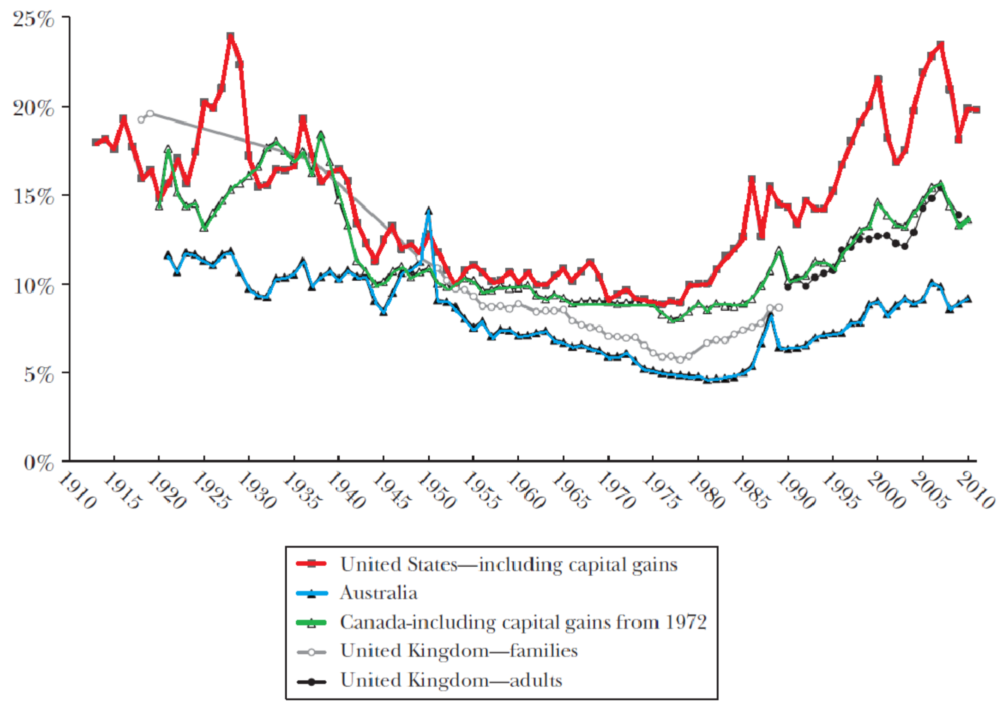
Against this background, the objectives of this paper are three-fold. First, we evaluate the recent trends in inequality, using different sources to demonstrate its extent and progression. The effects of inequality on growth are examined, in line with the theoretical literature on the subject. Second, the possibility of setting up a Solidarity Fund is explored as a way to address in part the impact of increasing inequality that is so evident in many countries and regions. Third, the implementation and governance of such a fund is discussed and suggestions presented on the short and medium term goals.

1. Evidence about income inequality - a trend toward growing disparities

One of the latest empirical studies of the OECD on inequality confirms that in 75% of OECD countries, the top 10% household incomes grew faster than those of the poorest 10% over the 20 to 25 years, causing a broadening of income inequality (Cingano, 2014).

According to the renowned Kuznets hypothesis, income inequality should acquire an inverse-U shape along with technological progress, first increasing with industrial development and then declining, as employment in the high technological sectors of the economy increases (Kuznets, 1955). The Kuznets curve has been widely questioned, especially in the United States, with inequality decreasing during the first half of the twentieth century and then, rising again from 1970s onwards. This does not necessarily invalidate the Kuznets' hypothesis. It is plausible to state that since the 1970s a new industrial revolution has occurred, and the latter represents a new inverse-U curve with first, increasing inequality, and then inequality decreasing again at some point, as more workers join the high productivity economic sectors (Piketty Th. and Saez E, 2003).

A: Top 1 Percent Income Shares in English-speaking Countries (U-Shape)



Source: Alvaredo, Facundo, Anthony B. Atkinson, Thomas Piketty, and Emmanuel Saez, "The Top 1 Percent in International and Historical Perspective", Journal of Economic Perspectives, 27(3): 320, 2013

Indeed, Robert J. Gordon identifies three industrial revolutions that shaped the modern world (Gordon, 2015). In each case Total Factor Productivity (TFP) growth reflects the gains made by technological progress. For example the rapid "TFP growth during 1920-1972 reflects the dynamics of the industrial revolution that created the modern economy, including steam engines, railroads, steamships and the transition from wood to metal. The second industrial revolution relates to the invention of electricity and the combustion engine. At about the same time as the impact of the second industrial revolution began to encounter diminishing returns after 1970, along came the digital electronic third industrial revolution, the gains of which are clearly reflected in the productivity upsurge of 1996-2004". However, this was "followed by mediocre productivity growth in the decade after 2004". Gordon shows that the benefits from the internet and web revolution have been largely absorbed by 2004 and the methods of production have been little changed over the past decade. He argues that the many accomplishments of the third industrial revolution are largely completed. In terms of the Kuznets curve we are now stuck at the high end of the curve and unless a new technological revolution kicks in, TFP growth is expected to remain restrained.

Going forward, TFP growth seems to be stagnated on two fronts. First is the diminishing returns from the third revolution, and second; to the extent that educational attainment is rising less rapidly than in the past, the future growth rate of productivity will tend to be slower. Gordon also finds that "the cost of a university education has risen since 1972 at more than triple the overall rate of inflation". Moreover, "the increased number of children growing up in single-parent households is likely to cause further erosion in educational achievement" and Gordon refers to this changing family structure as 'socioeconomic decay' which implies that "for the first time, America's children will almost certainly not be as well educated, healthy or wealthy as their parents."

1.1 Empirical findings of rising inequality

Strong empirical evidence suggests a long-term trend towards higher inequality (Cingano, 2014,). During the crisis, most OECD countries registered historical highs of income inequality. Latest data suggest that the richest 10% of the population in OECD countries have an average income of around 9.5 times that of the most deprived 10%. In the 1980s, this ratio was 7:1. However, results diverge amongst OECD countries. Inequality is less pronounced in the Nordic and many Continental European countries, but is relatively high in Italy, Japan, Korea, Portugal and the United Kingdom, and reaches its highest levels in Mexico and Chile.

These ratios cannot be taken as conclusive, however, since they are based on only two values in the income distribution. A more commonly used indicator, which takes into account the whole distribution, is the Gini coefficient. This measure takes the value of zero (when all the distribution has an identical income) or 1 (when one person obtains all the income). In the mid-1980s, the Gini coefficient was at 0.29, on average, among OECD countries. However, by 2011-12, it had risen by 3 points to 0.32 (Cingano, 2014). For most of the countries for which long time series are available, the Gini coefficient followed an upward trend, increasing by more than 5 points in Finland, Israel, New Zealand, Sweden and the United States, but decreasing marginally only in Greece and Turkey.

Income inequality evolution widely differs among OECD countries. Income inequality first started to rise in the late 1970s and early 1980s in the United Kingdom and the United States. Income inequality extended in the late 1980s. During the 1990s and early 2000s the gap between the poor and the rich increased in some of the countries with an already high level of inequality, such as Israel and the United States. What is important to note is that this gap widened for the first time in Germany and the Nordic countries, which are known for low inequality. With the beginning of the financial crisis, increasing net income inequality was less visible in many countries. However, since 2010 inequality is on the rise again.

Income inequality among advanced economies and emerging and developing countries (EMDCs) can also be studied through an analysis, based on the poor and the middle class. A recent study by the IMF (Dabla-Norris, 2015) builds on a larger sample of countries while considering the income shares of the poor and the middle class, the main growth drivers. A panel econometric approach is used to put together different interrelated parameters that matter for inequality with year and country fixed effects. A sample of almost 100 advanced economies and EMDCs over the period 1980–2012 is assembled to determine the causes of country variations of income inequality. This research uses a large group of countries and examines if the determinants of inequality change across advanced, emerging markets and developing economies, and across different measures of inequality. In addition to the Gini coefficients, it develops the argument that income distribution itself is a precondition for growth by analysing "the determinants of the disposable income shares of the poor (bottom 10 percent), the middle-class (fifth decile), and the rich (top 10 percent)" (Dabla-Norris et al., 2015). A greater emphasis is then attributed to the determinants of income concentration in recent years, especially as regards to the poor and middle class income shares.

This analysis suggests that

- The rise of inequality in both advanced economies and EMDCs is due to technological progress and the consecutive rise in the resulting skill rewards. Globalization has a limited role although it appears it has contributed to growing inequality.

- Social policies focused on the low and the middle class can reduce inequality. Health care and eased access to education, as well as optimal social policies can be inclusive and thus, reduce inequality for the poor and the middle class.

- There are various approaches to analyse inequality. Drivers of income inequality and country specifics should determine the nature of equality friendly policies. In advanced economies, measures against inequality should aim at developing human capital and skills, while implementing a more progressive taxation system. In EMDCs, since the results of the IMF study suggest that financial complexity results in higher income inequality, improved financial inclusion and "incentives for lowering informality would be important"… More generally, complementarities between growth and income equality objectives suggest that policies aimed at raising average living standards can have an impact on the distribution of income by ensuring a more inclusive prosperity" (Dabla-Norris and al., 2015).

1.2 Empirical evidence showing the negative effect of inequality on growth

The above mentioned OECD study develops an econometric analysis using harmonised data for the OECD countries over the past 30 years, and finds evidence that income disparity has a "negative and statistically significant impact on subsequent growth" (Cingano, 2014). In particular, the income inequality difference between the poor households and the rest of the population seems important. In contrast, the gap between the high income households and the rest of the sample seem to have no negative impact on growth. The OECD study "also evaluates the human capital accumulation theory finding that human capital is a channel through which inequality may affect growth. Analysis based on micro data from the Adult Skills Survey (PIAAC) points out that rising inequality weakens skills development for individuals with poorer parental education background, both in terms of the quantity of education attained (e.g. years of schooling), and in terms of its quality (i.e. skill proficiency)" (Cingano, 2014). This finding concurs with that of Gordon mentioned earlier.

Previous IMF studies have found that income inequality (as measured by the Gini coefficient) has a negative effect on growth and its sustainability (Ostry, Berg, and Tsangarides 2014; Berg and Ostry 2011). A more recent IMF study develops this analysis (Dabla-Norris and al., 2015). It evaluates the impact of individuals' income shares on growth by using an exhaustive sample of advanced economies and EMDCs. A higher net Gini coefficient is concomitant with lower output growth over the medium term, consistent with previous findings. The study finds an inverse relationship between the income share attributed to the rich (top 20 percent) and economic growth. If the income share of the rich (fifth quintile) increases by 1 percentage point, GDP growth is affected negatively, and decreases by 0.08 percentage points in the following five years. A similar rise in the income share of the poor (the bottom 20 percent) results in a 0.38 percentage point increase in growth. This positive correlation between disposable income shares and higher growth is valid also for the second and third quintiles (the middle class). This result is consistent with recent research results for a smaller sample of advanced economies (OECD 2014).

Widening income disparities affect growth because they weigh on its drivers. For example, higher inequality dampens growth by reducing the ability of lower-income households to access medical care and accumulate physical and human capital (Galor and Moav, 2004), (Aghion, Caroli, and Garcia-Penalosa 1999). Moreover, high income inequality has a negative impact on the social mobility across generations, since the poor parental background would tend to be transmitted to the generations to come (Corak, 2013). This result is in line with Gordon's concept of socioeconomic decay (Gordon, 2015).

In addition, inequality discourages investment, and consequently growth, by creating economic, financial, and political instability (Dabla-Norris et al., 2015). More importantly, economic analysis finds that a global financial crisis could be triggered by a prolonged period of higher inequality in advanced economies by augmenting leverage and by altering credit dynamics (overextension of credit, and a relaxation in mortgage-underwriting standards) (Rajan, 2010).

1.3 Theoretical literature on the effect of inequality on growth

Alternative theories predict that inequality can affect growth in a negative direction. Greater inequality might reduce growth if:

a. Higher inequality could lead to voters favouring policies of higher taxation and state regulation, thereby discouraging investment. (By reference to the "endogenous fiscal policy" theory, Bertola 1993; Alesina and Rodrick 1994; Persson and Tabellini 1994; Bénabou, 1996; Perotti 1996). In extreme cases, inequality may cause political instability, with detrimental effects on growth (Knack and Keefer, 2000).
b. In presence of financial market imperfections, poor individuals may not have access to opportunities such as full-time education. That would eventually force them to underinvest by renouncing to the latter, which, in turn, would decrease the aggregate output more than in the case of perfect financial markets. (Galor and Zeira, 1993).

2. Curbing inequality through a Voluntary Solidarity Fund (VSF) at the national or regional level

The preceding section leads to the conclusion that the sources of the worsening income inequality are various. In this context, it is likely that any measure to reduce income inequality needs to be seen in the perspective of a holistic approach involving individuals, societies and institutions. It is no mere accident that institutions such as the IMF, OECD and others have been increasingly vociferous about the negative effects of increasing inequality during a period of subdued economic growth and stagnant productivity growth in most advanced countries and a number of emerging developing countries. In a period of vibrant economic and productivity growth, the impact of increasing inequality may be subsumed by a rising standard of living, albeit at different speeds. However, in today's context of slower growth, the economic and social impact of increasing inequality becomes an issue of significant importance, possibly also to the cohesiveness of societies and fundamental economic relationships.

While this economic and social dimension is important and very relevant, the fundamental driving force that would address income inequality has to originate from the individual's value of solidarity which is defined by Pope Emeritus Benedict XVI in his Caritas in Veritate (2009) as "first and foremost a sense of responsibility on the part of everyone with regard to everyone". Solidarity demands therefore that we work towards the common good; in other words, towards the creation of communities in which all people are able to flourish and achieve fulfilment. This is probably best described by Pope Saint John Paul II in Sollicitudo Rei Socialis (1987): "When interdependence becomes recognized in this way, the correlative response as a moral and social attitude, as a 'virtue', is solidarity… not a feeling of vague compassion or shallow distress at the misfortunes of so many people, both near and far…[but] a firm and persevering determination to commit oneself to the common good; that is to say to the good of all and of each individual, because we are all really responsible for all."

Therefore, the starting point of any measure aimed at reducing income inequality is the individual. The Foundazione Centesimus Annus is assembled around the principle of promoting the study and diffusion of the social doctrine of the Catholic Church. It is therefore well-placed to propel the line of thinking expressed by Pope Emeritus Benedict XVI and Saint Blessed John Paul II. It is not that other mandatory or voluntary contributions at the institutional or charitable level would not be effective or appropriate, but as a Foundation built around the principles of Catholic social teaching, the idea of self-realisation and 'voluntary willingness' needs to be propelled as the starting point to address income inequality.
A solidarity fund on a voluntary basis and motivated by the moral standards of the individual's conscience, with the central objective of reducing income inequality by enabling individuals to better their capacity to participate in the economy and earn a dignified living through their work, would be in line with the Foundation's fundamental principles. Consistent with the principle of subsidiarity that asserts that problems should be dealt with at the most immediate or local level, the solidarity fund would be more effective to initiate at the national or regional level. This would also add to the individual's incentive to contribute, and at the logistical level, it would be more practical to implement. An additional motivating factor would be to structure the fund in a way that gives the contributor the faculty to determine how the contribution would be invested to address the ultimate objective of income inequality. This is not to overemphasise conditionality, but rather to encourage participation in a viable and effective project.

This perspective is not Utopian. For instance, in the US, the Gates Foundation (BMGF or Bill & Melinda Gates Foundation) is the largest private foundation in the world, founded by Bill and Melinda Gates. The primary objective of the foundation is, globally, to enhance healthcare and reduce extreme poverty, and in America, to expand educational opportunities and access to information technology. Another example is the Buffett

Foundation (Susan Thompson Buffett Foundation) which is a charitable organization formed by US investor Warren Buffett as a vehicle to manage his charitable giving. In June 2006 Buffett announced that he would give 85% of his wealth to the Bill and Melinda Gates Foundation.

Perhaps, one way to implement this Voluntary Solidarity Fund (VSF) is to bring together a number of middle to high net worth individuals, including prominent individuals that embrace the concept of solidarity being propelled by the Foundation. Besides monetary contribution, this private non-profit entity would propagate the notion that more income equality is beneficial both from an economic as well as from an ethical dimension. To this end, the act of contributing part of the wealth or income is deemed as a noble act in itself and part of taking responsibility for others.

As a concrete proposal, I would suggest that the broad parameters would have the following guidelines, namely individuals earning the equivalent of EUR 100,000 to contribute 1% of their income annually, while those earning above EUR 200,000, to contribute 2% of their income annually. These percentages are not mandatory but a guide. It is after all a voluntary fund. Individuals earning less than EUR 100,000 may decide to contribute at the same or a lower rate. While individuals earning a higher income than EUR 200,000 may contribute at a higher rate. The ideal scenario would be that an individual feels comfortable that she or he are meeting their moral obligation to be responsible for others who are less fortunate than themselves and who may be caught in a low-income or even a poverty trap. The shareholders of a company could also decide to contribute from the company's earnings. Corporations could be invited to present their shareholders with a proposal to contribute 1 or 2% of the company's profits, and the shareholders invited to vote on this proposal.

An eventual establishment of a VSF would need to be built around a strong governance framework supported by adequate technical and managerial competence, organisational capacity, accountability and transparency, all elements that current members of the Foundation have significant expertise in. The VSF would inevitably include an internal audit process as a catalyst for ensuring its governance, risk management and management controls. Moreover, the VSF would be audited externally to ensure full transparency. These are fundamental pre-requisites for the Fund's success in bringing together a network of individuals or groups of individuals that share this philosophy and are ready to take initiative.

With a strong governance framework and supported by a network of important and trustworthy people, the VSF could earn an important role within the civil society, eventually placing itself on the negotiating table with other members of the civil society and the public administration where it could voice its philosophy and actively stir the public discussion towards its genuine target. The VSF would be in a strong negotiating position as it would have the capacity to actively contribute even financially. The status of the Fund would enable it to fulfil its role in civil society without prejudice. Based on the fundamental principle of solidarity, it has the potential to have a universal appeal to all segments of society, whatever the religion, race, colour, or political belief. The Foundation would not only give voice to the weakest members of society but it would also influence policy makers to take political decisions that would favour their well-being. In a way, the VSF is envisaged to have a role similar to that of the European Investment Bank (EIB) or other well established development banks such as KfW of Germany and many other similar institutions, and established at the national or regional level. The EIB acts as a catalyst for investment, providing finance and expertise for sound and sustainable investment projects which contribute to furthering EU policy objectives. It fulfils its role in a three-way manner by lending, blending and advising with its ultimate priority being contribution to growth and employment in Europe. Consistent with the philosophy of EIB, the VSF could utilise the funds to contribute to reducing inequality by addressing fundamental issues such as access to education, access to the labour market for young people, access to adequate healthcare, supporting the elderly and so forth. It could do this by directly funding projects or else by acting as a strategic partner with the government where the VSF could act as a catalyst for addressing long-standing issues that would improve income equality and enable an environment where all members of society can achieve fulfilment. The VSF could also use the funds as a guarantee for very cheap loans by the private sector for the purpose of education or to assist families to get access to adequate housing. The VSF could also use its financial resources as collateral to borrow from the EIB for the purpose of investment that would target the priorities of the VSF and the EIB simultaneously. In this way the VSF could leverage on its funds to extend its reach and scope.

At a future date, it may also issue its own bonds rather than rely purely on contributions from individuals, though this is a medium term consideration, since it requires an organisational structure appropriately developed to cater for such an activity. However, in a low interest rate and high liquidity environment, one should not exclude the attraction of using one’s funds for a social purpose even at little or no pecuniary return, while still owning such funds. Society would be profiting from the use of such lent funds, rather than leaving them idle in some bank account or worse stashed in some safety deposit box.

As an initial impetus to the VSF it may also be worthwhile to have an injection of capital by the Catholic Church which for a temporary period could be linked to the amount contributed by the individuals. It would be a sign of willingness, commitment and endorsement by the Church, which would be particularly successful with the intervention of Pope Francis.

Furthermore, for the medium to the longer-term perspective I envisage an ambitious attempt to discuss this proposal with other Christian denominations and even go beyond

that and cooperate with other non-Christian religious organisations. The underlying fundamental principles of the Foundation are highly agreeable and they can bring together different religions in a historic cooperation among people of different beliefs towards a common goal. This dimension would further enable the Foundation to carry out its mission without prejudice.
A VSF of this nature is envisaged to be offering an opportunity for those who are willing to contribute but are usually uneasy on the methods and uses of funds. The VSF ensures an efficient use of resources by introducing a business-oriented dimension to the Fund. It would focus on the common and shared values of most religions and on solidarity as a value in itself. With this structure, the VSF could target segments of the society we live in that would provide the contributor with an immediate and visible result.

Conclusion

Income inequality is a top concern at the global level. There is general consensus that inequality is on a rising trend and that it could have negative effects on growth and on the well-being of society. At the personal level there is conviction that inequality is everyone's responsibility that goes beyond giving charity to the poor. It involves the transformation of society into a more equal one that would ultimately result in the enhanced well-being of everyone and a contribution to the common good.

Unfortunately, those individuals that embrace this commitment towards the common good may not be presented with the appropriate channels to contribute for this purpose. The VSF aims to bring together those individuals that have a vision of a more equal society and are ready to contribute for that purpose. Recent economic studies suggest that human capital is one of the main channels through which inequality has risen. In view of that, the VSF is envisaged to focus on access to education, healthcare, labour market access and other equality-seeking policies. This is a distinctive dimension of solidarity in the sense that it promotes a longer-term investment that would empower in a lasting manner the parts of our society that lack capital.

For reasons of practicality and logistical efficiency, the VSF would initially be set up at the national or regional level, though still supported by the centralised Catholic Church. At the operational level, the VSF could adopt a similar philosophy to that of the EIB whereby it could use the funds to lend, blend and advise. Moreover, the priorities of the VSF may at times coincide with those of the EIB and in that case, the VSF could use its funds as collateral to borrow from the EIB and implement projects that fulfil the aims of both the EIB and the VSF.

At the management level, the VSF would be supported by a very strong governance framework that would be needed to lift the VSF to prominence, empowering it to actively participate in the civil society and to stir the public debate towards its genuine objectives. In partnership with the government, and with the monetary support of its funds, the VSF could embark on important projects that improve income equality.

With this structure the VSF is envisaged to fulfil its objectives efficiently, effectively and economically, enabling it to extend its scope and reach with its primary role being to enhance the capacity of individuals to earn a decent income and live a fulfilling life. It will also provide a major avenue for individuals who are in the medium-to-higher income groups to contribute to the betterment of others, to enable them to provide solidarity in an effective and practical way.

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