## The Gurus changed their minds

It does not often happen that the conventional wisdom of the day gets turned upside down. Yet that is what has happened to some cherished ideas on labour market flexibility and inequality. What is more, the turning-upside-down was done by two citadels of economic thinking, the IMF and the OECD.

### The IMF and labour markets

In April the IMF published its annual World Economic Outlook. IMF staff had researched the impact that changes in regulations in product and labour markets had on multi-factor productivity; or in ordinary English, how deregulation helps economic growth. This whole process is also called "structural reform". The researchers studied 16 economies of which 10 were developed and 6 developing countries. Combined, the 16 were responsible for 75% of world economic output in 2014. Big sample size.

Tucked away at the end of Chapter 3 came the predictable conclusion that regulatory changes in product markets and particularly the service sector lead to increased productivity because it causes more competition. In the short term there may be negative effects, but in the longer run the effects are positive.

On labour markets, however, the report came to the amazing conclusion that changes in regulation had no positive impact at all on productivity. I will repeat that: in the 16 economies studied, structural reform to labour markets rendered no positive outcomes to total factor productivity. On the contrary, the report found there were ONLY negative effects associated with labour market reform. This clearly flies in the face of the constant refrain, inter alia from IMF staff itself, that labour market reform is a pre-requisite for higher productivity.

No wonder then that Olivier Blanchard, chief economist of the IMF, cautioned at a press conference releasing the report "I think one has to be very clear that structural reforms are not a miracle cure. They are hard to get through; the effects are very often **uncertain**." (my emphasis)

In the same Chapter 3 the IMF formulated its policy advice based on this research and advised: "In emerging market economies, higher **infrastructure** spending is needed to remove critical bottlenecks, and structural reforms must be directed at **business conditions**, **product markets**, and **education**." (my emphasis). No reference whatsoever to labour markets.

Reading all this I recalled an experience I had in March 2014 at the University of Pretoria's Business School, GIBS. A number of people, more than half of them with a business or economics background, participated in a discussion on growth. Participants had to write down constraints on SA growth on little pieces of yellow sticky paper. When the results were grouped together and displayed on a board not one, yes not one, person had mentioned the labour market as an issue. And there were some serious business and economic heavyweights in the room, some of whom have publicly called for labour market reform.

The GIBS experience taught me there is the loud noise of people calling for labour market reform and then there is the real thinking. The IMF has now confirmed the real thinking.

## The OECD, IMF and inequality

In May 2015 the OECD, an organisation of 34 countries based in Paris with the aim to promote policies and ideas that will enhance growth, published a seminal report on inequality. In it the learned writers came to the conclusion that higher inequality drags down economic growth. This also turns a decades' old wisdom on its head.

The traditional wisdom had it that efficiency (growth) and equality are in an adverse relationship – more of the one will give you less of the other. You cannot have your cake (growth) and eat it (equality). The American economist Arthur Okun's classic textbook *Equality and Efficiency: The Big Tradeoff* dominated the thinking on the topic.

Not so, said the OECD in its report. "It (inequality) tends to drag down GDP growth, due to the rising distance of the lower 40% from the rest of society. Lower income people have been prevented from realising their human capital potential which is bad for the economy as a whole." The OECD calculates that "The rise in inequality observed between 1985 and 2005 in 19 OECD countries knocked 4.7 percentage points off cumulative growth between 1990 and 2010." That is more than enough to compensate for the recession caused by the global financial crisis of 2008/09.

The OECD report is a particularly big nail in the coffin of growth-and-inequality-are-in-opposition thinking. But it is not the only one.

### IMF

The IMF has come to a similar conclusion in a report it released in 2014. The writers compared data from 153 countries and concluded (as summarized by Donaldson): "First, higher inequality appears to have a statistically significant negative impact on growth. Using the USA as an illustration, an increase in the net Gini coefficient of 5 points from its current value of 0.37 (to 0.42) would be expected to reduce the medium-term growth rate of per capita GDP by 0.5% per annum." (For my penny's worth, this is a massive number – SA would give anything to have 0.5% higher growth per annum.)

"Secondly, redistribution has a tiny negative but statistically insignificant effect – it appears to have an all but zero effect on growth."

Donaldson concludes: "Thus the combined direct and indirect effects of redistribution – including the growth effects of the resulting lower inequality – are on average pro-growth."

## Caution

That giant of economic thinking, Dani Rodrik from Princeton, challenges (as he always does) this new consensus and lists a number of cases where rising inequality can in fact go hand-in-hand with growth and economic advancement. He appropriately warns: "Economics is a science that can claim to have uncovered few, if any, universal truths. Like almost everything else in social life, the relationship between equality and economic performance is likely to be contingent rather than fixed, depending on the deeper causes of inequality and many mediating factors. So the emerging new consensus on the harmful effects of inequality is as likely to mislead as the old one was."

I read that as keep an open mind, be aware of the context, avoid ideology. Common sense and a knowledge of the context matter.

## So what?

- It is clear that big shifts are taking place in economic orthodoxy, supported by empirical evidence. No doubt there will be contestation and argument, but the "obvious" policies on labour markets and inequality are no longer so obvious.
- Nuanced new policy ideas are in order. More than ever, reject dogma and ideology be it from the left or the right.
- As far as labour market go we can safely ignore the noise and hysteria (also from the IMF!) on "reform" and focus on the real issues, like how to get more jobs going.
- On inequality it may appear as we can now have our cake (growth) and eat it too (equality). Common sense tells one that will require a lot of skill and fine balancing, as Rodrik correctly cautions. Eating your cake and having it requires a lot of superb co-ordination.
- As always, the trick is to take note and learn, but not to get carried away. Retain common sense and sound judgement and have a firm grip on local context. Countries and conditions differ. What may work in Scandinavia may not work in Venezuela.
- Rodrik again: "It is good that economists no longer regard the equality-efficiency trade off as an iron law. We should not invert the error and conclude that greater equality and better economic performance **always** go together. (my emphasis) After all, there really is only one universal truth in economics: It depends." Amen.