Global Agenda Council on New Growth Models

Investing in Inclusiveness, Sustainability and Growth

January 2016

INVESTING IN INCLUSIVINESS, SUSTAINABILITY AND GROWTH

The Global Agenda Council on New Growth Models

In 2015, the global community advanced its commitment to searching for new growth patterns that advance prosperity broadly and in a sustainable manner. In New York in September 2015, the Sustainable Development Goals (SGDs) were adopted at the United Nations, with near universal support and commitment. In Paris in December 2015, major commitments were made to progress on dealing with CO_2 and other greenhouse gas emissions and climate change. These are important advances.

However, strikingly, the reality looks very different. The global economy and many of its constituent elements are not even close to being on track to achieving the goals embodied in the SDGs under the broad headings of growth, inclusion and sustainability. In fact, growth is faltering, inequality is rising, the global economy is fragile, out of equilibrium in multiple dimensions and at risk of a major setback.

In this somewhat bleak landscape, it is important to be realistic about the challenges and to seek ways to address them. But there are real opportunities as well. Redirecting resources in a way that changes the growth patterns can help solve the immediate challenges to the level and quality of growth, locally and globally.

Investment and the Balance Sheet Underpinnings of Sustainable Growth

There is a broad pattern of underinvestment (both public and private) and excessive reliance on leverage and elevated financial asset prices to sustain aggregate demand. This has led to a temporary and partial relaxation of the pervasive demand constraints on growth, but it is a pattern that cannot be sustained. The reversal of these trends is crucial to restoring and sustaining balanced growth.

Underinvestment means that the balance sheet foundations of sustainable growth patterns are being systematically eroded. Key assets on the economy-wide balance sheet include physical capital, digital capital, intangible assets in the form of human capital, technology, knowledge and capabilities embedded in institutions, and natural capital. All of these need to be maintained and augmented to produce sustainable growth patterns and to provide resilience through shocks and major structural transformations.

A gallant effort to measure the contribution of each of these assets to a country's wealth is done by the World Bank.[1] We need to think in terms of targeted investments in pursuit of each of the three broad goals: restoring growth, expanding inclusiveness and achieving sustainability. Investing to achieve better outcomes in terms of inclusiveness may positively influence growth. But if inclusiveness is a real priority, we don't have to and should not stretch to link the social returns of that investment to growth to justify it.

Secular Structural Change: Technology and Globalization

The integration of global markets and digital technologies have produced and will continue to cause rapid shifts in the structure of economies, labour markets, and the nature and composition of employment.

[1] *The Changing Wealth of Nations* (2011) presents a set of "comprehensive wealth accounts" for over 150 countries for 1995, 2000 and 2005, which allows a longer-term assessment of global, regional and country performance in building wealth.

Much of this is positive. There have been tremendous gains in prosperity resulting from global integration and developing country growth, though the process of convergence is far from complete.

The latest poverty numbers released by the World Bank[2] are encouraging and that is unambiguously good. One can expect this to continue in the next 15 years. Though the growth rates may be lower in developing countries, poverty reduction will continue and the growth patterns could be more inclusiveness. Largely eliminating poverty is not out of reach, though it will absolutely depend on overcoming the recent broad-based slowdown in emerging economies. Health outcomes in developing countries have improved very substantially.

However, both the global economy and individual economies within it are in the process of major structural transformations. Inevitably, markets are out of equilibrium and in transition. Growth and productivity lag as a result. People lose their jobs or suffer significant income reductions as the value of their particular skill set declines.

As globalization and technology alter labour markets and the composition of employment, the human capital base of the supply side has to change and it struggles to keep up. This has led to job polarization in advanced countries and contributed to widening income inequality.

There are other sources of disequilibrium. Misestimates of future growth put markets out of equilibrium, the natural resource markets being a current example.

Policy Frameworks

Policy frameworks at national and international levels are presently neither comprehensive nor robust enough to meet these challenges.

There has been excessive reliance on monetary policy in post-crisis recovery programmes, with complementary investments and fiscal, structural and regulatory reforms lagging behind. This is not a criticism of monetary policy, but rather of the absence of complementary reforms, designed to restore growth and adapt to the new economic realities. The result has been limited progress in restoring growth or expanding inclusiveness. Asset prices did respond to low interest rates and have become disconnected from economic fundamentals. Risky incentives to return to growth patterns with excessive and unsustainable amounts of debt are increasing.

Inequality and Distribution

High and rising inequality is a multiple threat. In many ways, it is the Achilles heel of the present growth patterns. It jeopardizes social and political cohesion particularly when it emerges from unfairness in the form of rent-seeking behaviour.

Especially when combined with deficiencies in the public provision and/or funding of critical social services like education and healthcare, rising inequality adversely affects economic and social mobility, a key shared value in most societies.

A failure to adjust social security and income distribution policies to counter some of the distributional impacts of the structural transformations referred to above leads to anti-globalization and nationalist political sentiments.

Finally, redistribution, both through the provision of public services and directly via income redistribution though the tax system, is pro-growth – provided it is not extreme – in two important respects. First, it increases the capacity of individuals to invest in their skills and human capital and hence accelerates the supply side adjustment of the labour market, which itself has positive

[2] See the World Bank's *Global Monitoring Report, 2015* for more details.

distributional effects. Second, in the context of demand-constrained growth, it also positively affects demand and, to some extent, relaxes that constraint. Thus, from both supply-side/productivity and demand-side perspectives, multidimensional interventions to reduce inequality have positive effects.

Against that, the traditional economic argument has been that redistribution (mainly via taxation) adversely distorts incentives to work and to invest in productive human capital. So, the question is whether the positives outweigh the negatives. There is a growing body of research across a range of countries and economies which indicates that a balanced and non-extreme approach to reducing inequality has a net positive effect on growth, social cohesion and the ability to run a dynamic, innovative, open economy.

Distributional dimensions of growth patterns, long neglected in policy discussions, have made a comeback at least in terms of attention, supported by highly useful research and a vigorous debate. Research on education and early childhood experience[3], the multifaceted impact of new technologies, the effects of global economic integration on economic structure and jobs, and the pursuit of "rents" have improved the data, clarified the challenges and suggested directions for change, even if widely accepted or complete answers remain elusive.

In many countries at present there is no general agreement on what levels and types of inequality are acceptable and which ones require policy intervention. But there may be baseline shared values: those relating to poverty and to equality of opportunity come to mind. An important prerequisite to effect intervention is the forging of a political consensus on equality. It will not be the same in every country. Values differ. But whatever it is, it is better than gridlock and inaction.

Measurement

There is widespread if not universal agreement that growth is not an adequate measure of economic and social performance and progress. Absent supplementary balance sheet measures (referred to above, it does not tell you whether the growth pattern is sustainable. It does not capture distributional trends which affect both the level and quality of growth. And it does not capture important dimensions of the quality of life, such as health, which may or may not have a two-way causal relationship with growth.

Multidimensional measurement of economic and social progress has gained some ground but has not yet won the day. Governments do not yet systematically set priorities with respect to growth, inclusion and sustainability and then measure and report progress. Measurement is crucial. There is a fair amount of data on economic and social performance beyond simply growth. But it is dispersed. Assembling it in an easily comprehensible form is hard work, and having everyone do it for themselves is extremely inefficient.

Some (GPI for Genuine Progress Indicator and GNH for Gross National Happiness) advocate replacing growth with another single measure that aggregates a broader set of measures of the quality of growth. Single measures attract attention. But they mask the location of areas of strength or improvement and weakness. We believe it is better on balance, to use a multidimensional measurement system to track progress – a dashboard approach. We further believe that governments (national and subnational) and international organizations should set medium-term goals for progress in each of the three areas, work to find ways to make it happen, and report results. The Sustainable Economic Development Assessment (SEDA) developed by the Boston Consulting Group is a useful, concrete example of implementation of a multidimensional approach to measuring well-being and assessing change and progress.

[3] See, for example, on the importance of Early Childhood Development: "No Small Matter The Impact of Poverty, Shocks, and Human Capital Investments in Early Childhood Development, World Bank 2011

Ironically, from our point of view, there has been limited progress in restoring global growth, upon which, if one believes the commentary, we have until recently been fixated to the exclusion of other dimensions of economic and social performance. In the six and a half years since the start of 2008 before the onset of a rolling series of crises, the advanced economies have grown an unimpressive cumulative total of about 6%.

Growth and Fiscal Space

Growth is still important, and reversing the faltering global growth trends is a prerequisite to meeting a number of challenges. Unemployment is high; growth is needed to bring it down. But perhaps more important is the widespread challenge of fiscal distress.

Restoring public balance sheets will be difficult in the absence of nominal growth. But real growth is slowing in part because of the effect of real (or imagined – it depends on the particular case) fiscal constraints with a negative impact on public sector investment targeted at all three areas. In addition, inflation is stubbornly well below targets, further constraining nominal growth. A number of overly indebted sovereigns are dependent on low interest rates, maintained by central banks, for fiscal stability. However, those low interest rates that stabilize sovereign debt markets in the short run diminish the pressure and incentives for difficult growth-oriented reforms. For fiscal rebalancing, this constellation of factors has the feel of a trap.

Infrastructure investment has been negatively impacted, and thus also growth. Other components of public investment (human capital and science and technology) are also under stress. This damages longer-term growth potential.

In addition, longer-term liabilities are piling up on public balance sheets as the full impact of rising longevity hits. Prolonged periods of low interest rates exacerbate the problem by reducing the expected return on the assets that back the liabilities (think of public pension funds) and hence increase the magnitude of the unfunded longer-term liabilities.

The world is re-leveraging rather than the reverse, generating demand in a way that is not sustainable. The McKinsey Global Institute estimates that the global economy has added roughly $57 trillion of debt since the start of the rolling series of financial crises.

Aggregate demand itself is short of what is needed to fully utilize labour and capital resources. It is a deflationary environment. Inflation is below targets and it is not yet clear whether monetary policy alone can overcome this.

Commodity prices have reset downwards as post-crisis growth forecasts slowly converged downwards toward actual performance. This reset has contributed fiscal stress and a slowdown in emerging economies and has destabilized a few of them. The advanced economies (about 50% of the global economy) have grown a total of 5% since the start of 2008 before the onset of the crisis, surely another factor in slowing developing-country growth.

Measured labour productivity growth is slowing, notwithstanding widespread trends in automation using digital technologies that, on the face of it, should have produced the opposite result.

Much of the hope for growth in developing countries requires investment. Urbanization on the global scale that has been forecast cannot succeed without massive investments. This, and broader investments required to sustain emerging economy growth, led the McKinsey Global Institute a few years ago to predict an investment boom in the global economy (an increase of 5%-6% of investment as a share of global GDP – a huge number), one that has not materialized so far.

Environmental Sustainability

Arguably, the greatest threat to long-term prosperity is climate change. It is also the most complex global challenge. Progress has been slow but nonetheless impressive. The challenge now, as time is running out, is to make a fairly rapid transition to an energy-efficient, low carbon-intensity economy that can grow without running down the natural capital upon which we all rely.

A set of vigorous complementary reinforcing steps are required. Businesses need to look to energy efficiency and many have made great strides already. Municipalities need to focus on building codes and urban transport systems. By far the most important step in terms of policy is to put a price on carbon, not so much for its short-term effect on the consumption of fossil fuels but rather to level the playing field for alternative energy technologies, both those that now exist and those that may be developed via investment in innovations.

Volatility and wild swings in the pricing of fossil fuels is also highly problematic with respect to incentives for, and risk to the returns to investment in energy-efficient technologies and low carbon alternatives. We think the G20 should take up the challenge of stabilizing or reducing the volatility of both the supply and the pricing of fossil fuels.

We remind ourselves that globally, much of the urban real estate and infrastructure that will exist in 30 years will be built between now and then. For sustainability, it is crucial that this massive investment programme occur within an energy policy framework that is clear (starting now) and that provides the appropriate incentives with respect to energy efficiency and carbon intensity.

Aggressively addressing sustainability in this dimension with investment, public-private partnerships and supportive policies is not only a challenge but also a major opportunity to generate growth and employment and to tap the innovative capacity of people and organizations worldwide.

Research on the “new climate economy” indicates that shifting to more energy-efficient and lower carbon intensity paths need not be particularly costly in terms of growth in the short and medium term. Of course in the longer term, the risks of major economic disruption of the high-carbon paths make them distinctly inferior. This is important because it undercuts the argument that raising energy efficiency and lowering the carbon intensity of the energy mix in the short run has a high price in terms of growth, which is already a challenge and hence we can’t afford to proceed with this now.

Reversing Deteriorating Fundamentals and Seizing Opportunities

In that spirit, what follows are steps that we believe will make a material difference on a five- to 10-year timescale, in all three dimensions of economic and social performance, in the level and quality of growth. These are not meant to be exhaustive or comprehensive but simply a good place to start.

Measurement

Making steady progress in moving to a reasonably comprehensive system of measurement of key dimensions of economic and social performance is an important priority and underpins much of the rest of the agenda. It is a key step in altering both policies and behaviour, and in stimulating innovative solutions.

More specifically, we believe it is useful to measure income growth across income distribution. It gives a picture of how income distribution is moving. In addition, there is a huge difference between rising inequality in a high- versus a low-growth environment.

As noted above, the dashboard approach with multiple measures of different aspects of economic and social performance makes the most sense to us. Use of existing data sources and measures where applicable makes sense, but bring them together in an easily understood dashboard will have a major impact and help move us away from a singular preoccupation with the conventional growth measure.

Measure instruments as well as final objectives, such as public investment, productivity growth, educational attainment, etc. No one would pretend that all of these are final objectives in the sense of being what people ultimately care about. But they do draw attention to key enablers. And they will help overcome policy myopia – roughly the notion that everything must be fine if current measures of performance are OK, until all of a sudden, it isn't.

Measuring various kinds of assets and liabilities, and/or the investment flows that cause key assets to rise or fall, is critical in dealing effectively with sustainability issues. As noted earlier, things don't break down immediately even when the balance sheet is being run down in one or several dimensions.

Growth

Growth in GDP has received much criticism as an incomplete measure of economic and social performance that gets too much attention just because it is there. This seems right. Furthering the notion that a wide range of important economic and social objectives is achieved semi-automatically along with growth seems clearly wrong. However, growth is still important. It is necessary but not sufficient for progress in a number of areas. It is the driving force behind poverty reduction in developing countries, a key element in generating employment, and essential in restoring fiscal balance for numerous overly indebted governments. It also generates resources for the sustainable funding of desired health, educational and other outcomes, and it makes redistributing income easier by making it a non-zero sum game.

Initiatives to restore growth will have many components, some domestic and some international. Much of what follows relates to restoring the level of growth and raising the quality of growth, including its sustainability.

Investing in Tomorrow's Workforce

The combined forces of digital technology and globalization are creating enormous opportunities and tremendous challenges.[4] To meet the latter and take advantage of the former, a significant adjustment in the human capital and skills base of many economies is required. Much of what concerns people, relating to job opportunity, income distribution and employment – in short, key elements of inclusiveness – are related to this rapidly shifting set of structural conditions. It calls for large-scale investments by governments (at all levels), by companies with skills needs and by individuals. There is a role for the public sector, with the support of think tanks and researchers, to produce educated forecasts of future labour market needs to help guide individuals, families and educational institutions make informed choices about investing in their skills and capabilities. There is no question that this has been a period of rapid change. Startling advances in robotics and artificial intelligence presage more, and perhaps even more rapid change in the future.

It is worth noting that the sharing economy is burgeoning, with networks and powerful platforms at the core. Under-utilized resources (assets and people) can be matched up with demand for a variety of services. These should be encouraged and not blocked by burdensome legacy regulatory systems. The potential benefits for employment and productivity are impressively large. However, the expansion of the sharing and gig components of the economy will require changes in social security systems, since many of the existing systems are tied to longer term and permanent employment – an older and different employment model.

Gender Inclusion and Equality

[4] See, for example, the World Development Report 2016: Digital Dividends (forthcoming).

By far the largest under-utilized resource in the global economy is its population of women. There are, of course, reasons based on ethics and values for addressing this persistent issue. It doesn't need to be and shouldn't be justified in terms of efficiency and growth.

Nevertheless, in the current global context of slowing growth, ageing, etc., the economic benefits of gender inclusion are enormous. The McKinsey Global Institute recently published a report suggesting that if full equality for women in education and the workplace were to be achieved globally by 2025, the increment to global GDP would be $28 trillion or 26% relative to the business-as-usual case.[5] Even if progress were limited to all countries achieving best in regional class levels, it estimates the increment to be $12 trillion or 11%. In short, there is a huge opportunity to address growth and inclusion issues simultaneously.

The blockages to full participation of women in various economies are multiple, complex and context-specific. The solutions will require creativity, commitment and persistence, and leadership.

Elevating Public Sector Investment to Promote Growth and Reduce Sovereign Debt

As noted earlier, shortfalls in public sector investment are ubiquitous. These shortfalls lower growth, contribute to the global shortfall in aggregate demand and in some cases adversely affect inclusiveness. There are reasons for these shortfalls: fiscal constraints; burgeoning non-debt liabilities related to health and ageing; and gridlock stemming from disagreements about the correct fiscal stance in the face of headwinds to growth.

Public investment needs to be separated from the rest of government expenditure and prioritized when it is clearly pro-growth. Over time the growth itself will help stabilize and improve fiscal configurations. Conversely, growth that is stifled by under-investment is self-defeating with respect to fiscal rebalancing.

That said, there are real constraints imposed by markets and political considerations. But there is another untapped opportunity in matching up large pools of investible capital (in pension funds, insurance companies and sovereign wealth funds) with public investment needs, especially in infrastructure. There are clearly blockages in the intermediation channels. If these blockages can be removed, with creative ways to reduce risk and provide an adequate return to investors, the benefits in expanding financing for investment in infrastructure could be enormous. These include elevated future growth globally, an immediate effect on aggregate demand, and more orderly urbanization.

Since choices about infrastructure directly affect the long-term sustainability of an economy (for example, its energy efficiency), our strong recommendation is that efforts to elevate public sector investment should have a strong sustainability focus (specifically energy efficiency) where appropriate.

Raising Productive Private Investment

One of the most striking features of the post-crisis recovery period is the weak rate of recovery of private sector investment in tangible assets. Investment in intangible assets, R&D, has held up somewhat better but not enough to overcome the overall shortfall.

Success in elevating public sector investment would promote private investment by raising the return to private sector investment and increasing competitiveness. However, deficits in public sector investment are only part of the story.

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[5] McKinsey Global Institute, *The Power of Parity: How Advancing Women's Equality Can Add $12 Trillio to Global Growth*, September 2015

Uncertainty is a negative for real investment. Regulatory uncertainty and, more generally, uncertainty about economic conditions, is a persistent problem. Poorly constructed tax or regulatory systems deter investment or divert investment into lower productivity channels.

The global pattern of extreme monetary easing (whatever it merits in specific contexts) has been accompanied by a shift in the deployment of corporate free cash to dividends, stock buybacks and financial investments and away from longer-term investment in incremental or more efficient capacity or new products.

In many countries, the financial service sector is not constructed to encourage or to fund investment in new ventures and innovative products or ideas. This represents a major drag on innovation, growth and employment, and in some areas has adverse effects on aspects of inclusion.

It is difficult to imagine a return to robust growth and a reversal of the downward trends in productivity without a substantial increase in private investment. A two-pronged approach seems to be called for. One is a rigorous examination of disincentives for investment in various categories, complemented by putting in place active incentives for investment in areas where the spillover benefits to the society at large are substantial.

Governance, Trust and Corruption

The loss of trust and confidence in a wide variety of institutions (government, business, academic) as measured in numerous surveys is substantial. Manipulation of systems for personal or institutional gain risks becoming the baseline expectation rather than the exception. These trends have numerous negative effects. In the internet age, the negative effects are amplified by the scope and speed of the dissemination.

Not all inequality is created equal. Meritocratic systems in which individuals' opportunities are based on talent and accomplishment and business organizations thrive based on competitive success are viewed relatively benignly almost everywhere, even when they generated unequal ex-post outcomes. On the other side, inequality generated by privileged access, relationships, corruption, buying influence or favourable treatment, is toxic with respect to social cohesion and governability. This applies not only to societies but also to organizations.

Distrust of government and other organizations spills over into constraints on their ability to act, even in areas where action is needed and there is no viable substitute. That is why in the developing country context, for example, government that fails persistently to pursue long-term public interest invariably produces inferior economic performance.

Given the informational asymmetries, there are good reasons for various sectors like finance and healthcare to self-regulate to some extent. But the track record has been at best variable and unimpressive.

The problem is not confined to government. In a hypothetical world of perfect information and fully informed participants, markets do a marvellous job of guiding resource allocation and creating incentives for innovation. But markets and self-interested behaviour can exploit vulnerabilities. And they do. Regulation is part of the answer but does not lead to the first best outcome. Values and trust are critical.

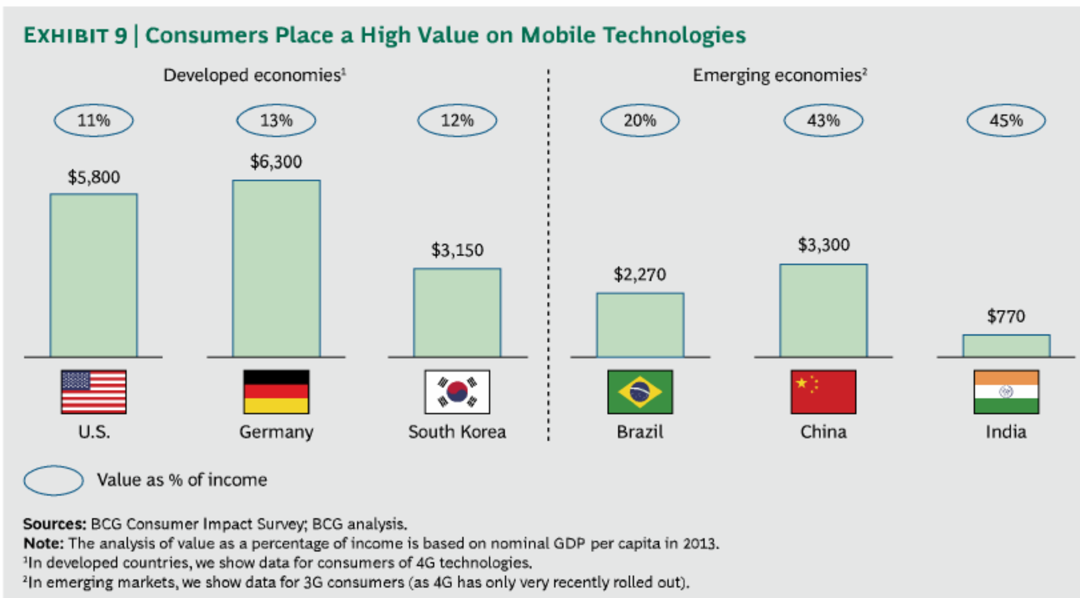
To some extent, responding to this challenge falls to everyone but especially to the leadership in organizations of all types, public and private. Leaders set the tone, communicate the core values (including responsibilities to society) and determine whether their systems are meritocratic in the broad sense. Over time this would restore trust, thereby creating a firmer foundation for tackling the more specific challenges that we face.

The Internet and Inclusiveness

One of the most powerful assets for promoting growth and inclusiveness is the internet and, more specifically, the smart or internet-connected phone.

About 3 billion people are connected now; another 4 billion are in the wings. The benefits are impressive in scope and quantitatively huge. A paper from the Boston Consulting Group[6] lays out the benefits in numerous dimensions, attached magnitudes, and identifies obstacles to connecting the remaining 4 billion people.

One of the most striking parts of the analysis is the value people put on connectedness via their mobile device. The Boston Consulting Group surveys suggest that people would give up substantial fractions of their income for their mobile connectedness.



The research estimates that, globally, these devices and related services generate consumer surplus (defined as the benefits to consumers in excess of the costs of the devices and services) of $6.4 trillion. This tends to support a proposition many already believe: that the conventional measures of growth based on market transactions seriously underestimate the growth in consumer benefits in digital technologies and services.

In addition, mobile internet has great potential to expand the business of SMEs and generate employment and growth.

The G20 under China

China has the G20 presidency in this crucial year. It is a unique opportunity to pull together a coherent programme to restore and sustain high-quality, sustainable growth paths. This cannot be done in a single year, but a credible plan would make an enormous difference.

[6] *How Adding More Mobile Subscribers Will Drive Inclusive Growth*, David Michael, Senior Advisor, Boston Consulting Group; Visiting Professor of Practice, UC San Diego School of Global Policy and Strategy; Member, Global Agenda Council on New Growth Models, Varas, Partner, Boston Consulting Group, Pete Engardio, Senior Writer, Boston Consulting Group

The key components of such a plan would include:

- Restoration of aggregate demand and reducing the deflationary pressures
- Restoring public investment, unblocking international intermediation channels to fund it
- Develop a set of policies to support the long-term transition to an energy-efficient, low-carbon economy
- Strategies and best practices for countering rising inequality in income and opportunity
- Promote structural reforms that allow economies to adjust efficiently to technological and global market forces
- Take steps to limit the build-up of leverage in the global economy, especially when widespread accommodative monetary policies create potentially dangerous incentives to leverage up
- Promote multidimensional measurement systems for economic and social performance as a step towards delivering on the commitment to higher-quality growth, the SDG's and the recent climate change commitments.

COMMITTED TO IMPROVING THE STATE OF THE WORLD

The World Economic Forum, committed to improving the state of the world, is the International Organization for Public-Private Cooperation.

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