Income-led growth in Korea
Issues, implications, and roles

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Abstract
The purpose of this article is to evaluate South Korea’s income-led growth policy, which is still under debate. Toward that end, it discusses the content and background of the theory of income-led growth as well as its implications for the Korean economy. Next, it considers the role of income-led growth as a strategy for growth in the Korean economy and offers some policy suggestions for the future.

The theory of income-led growth derives from the Keynesian tradition, a Western school of economic thought that emphasizes the role of demand in economic growth. The basic idea of income-led growth first appeared nearly 80 years ago, and the current model was framed about 30 years ago. Korean researchers began paying closer attention to the model after it was discussed by ILO researchers in 2010. The recent emphasis on income-led growth is due to the tendency for the labor share of income to decline and for polarization to increase globally since the second half of the twentieth century, creating a consensus that increasing inequality can hamper growth.

The effectiveness of the income-led growth strategy at bringing about economic growth by increasing labor’s share of the national income is theoretically and empirically debatable. But it is not hard to understand why the income-led growth strategy has emerged. Income-led growth is not a short-term strategy, nor is it likely to be the key strategy for growth. But under our current socioeconomic system, the prescriptions of income-led growth are meaningful in that they strengthen the integrity of the economic system, enabling sustainable growth. Furthermore, Korea, unlike the West, is a place where government welfare expenditure can play a significant role in income-led growth policy.

Keywords
income-led growth, labor income, economic growth, minimum wage

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Introduction

Intentionally or not, income-led growth has become the signature strategy for economic growth in the first half of Moon Jae-in’s term as South Korean president. Furthermore, raising the minimum wage has become his chief policy method for pursuing income-led growth. There has been serious debate about the effectiveness of a higher minimum wage, and indeed of the income-led growth policy itself, with positive assessments outnumbered by negative ones.

Given the intense debate about income-led growth, many people are aware of the general idea of this theory. It can be summarized as follows: Raising the minimum wage increases people’s income; higher income means more spending; and more spending helps the economy recover and prompts economic growth. That is how the theory goes, but people also have their own ideas about how this theory has actually worked in practice.

Those who see income-led growth in a negative light offer the following assessment: In actuality, raising the minimum wage caused the cost of labor to go up; this made things harder for small business owners, who had to cut their staff; and that reduced the number of jobs, causing problems for the low-income group. Needless to say, the economy is a long way from a recovery. Those seeking to cast a positive light on income-led growth offer the following take: While it’s true that raising the minimum wage has created some difficulties for small business owners, it has also raised the income for people in low-wage jobs. Some jobs may have been lost, but that can’t necessarily be blamed on the higher minimum wage. But regardless, since small business owners are having a hard time, the government ought to give them more support. And since raising the minimum wage alone can only go so far in increasing income for the low-income group, the government needs to expand welfare spending as well.

Both supporters and opponents of income-led growth appear to agree that the results of the policy in action have not matched its theoretical claims. The crux of the theory of income-led growth is that increasing the income of the low-income group by raising the minimum wage, among other measures, would stimulate the economy, leading to economic growth. But even those who support income-led growth do not claim that the minimum wage hike has actually achieved that. Where supporters and opponents of the theory diverge is on the question of whether the minimum wage hike has improved the lives of the low-income group or has reduced employment.

To be sure, it is important to gain an accurate understanding of how raising the minimum wage has affected the income and employment of the low-income group. But even supposing the effect there has been positive, would the failure to bring about economic growth mean that income-led growth itself was a mistake? And if so, what should our growth strategy be moving forward?
Income-led Growth: Background and Content

Before we can understand the reasons for the emergence of income-led growth theory, we must first examine shifting viewpoints on the labor share of income over the past few decades.

The Shrinking Labor Share of Income

The national income is the sum of the added value created in a given country. Both labor and capital are used to create the national income, so the resulting national income can be divided into the labor share and the capital share, or in other words labor income and capital income. The labor share of income signifies the percentage of the national income that labor income makes up.

The question of how the labor share of income changes over time, or in accordance with economic growth, is not so much theoretical as empirical. In the early twentieth century, Arthur Bowley discovered that the labor share had long remained at the same level (Bowley, 1920). For quite some time afterward, the stability of the labor share was a basic assumption in mainstream economics. This assumption was grounded in the fact that the labor share did in fact remain stable for about thirty years in the middle of the twentieth century, during the postwar boom (in the developed world) at the height of the industrial era. This assumption began to come into question in the 2000s, after clear evidence emerged that the labor share had been falling in advanced economies for more than three decades, beginning in the late 1970s (see Figure 1).

Figure 1. Changes in the labor share of income in advanced economies

Note: ADV is a simple average of 16 advanced economies (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Spain, Sweden, the United Kingdom, and the United States).
Source: ILO (2013), p. 43, Figure 31
The decline in the labor share that was exhibited by developed countries also occurred in Korea, following a time lag. The changes in Korea’s labor share are displayed in Figure 2.

**Figure 2. Changes in the labor share of income in Korea**

The labor share in Korea exhibited an upward trend from the 1980s until the late 1990s and shifted downward after the Asian Financial Crisis in 1997. The labor share fell by more than 10 points during the decade after the crisis. Considering that the decline in the labor share in advanced economies mostly became evident in the 1980s, the decline in Korea came after a gap of approximately twenty years.

The decline in the labor share has clear implications: more inequality and worse income distribution. Capital income generally goes to the high-income group, while the middle-income and low-income groups receive most of their income from labor. If the capital share of the national income is increasing and the labor share is decreasing, therefore, it signifies a corresponding weakening of distribution.

Thus, the traditional viewpoint has been to regard a decrease in the labor share as being a matter of distribution. But others think that such a decrease is problematic not only for distribution but also for growth. According to that alternative viewpoint, the decrease in the labor share and the corresponding worsening of income distribution also has a negative impact on growth. That is the argument made by income-led (or wage-led) growth.

**About Income-led (or Wage-led) Growth**

The original name of this theory is wage-led growth, rather than income-led growth. But the term whose use is preferred in Korea is income-led growth, so as to include the labor income of small business owners, who represent a large share of
the South Korean workforce. (Therefore, the “income” referred here should be taken to mean labor income, and not capital income.)

Basic Information and Empirical Findings

The theory of income-led growth derives from the Post-Keynesian school, the intellectual heirs of British economist John Maynard Keynes. The tendency among Keynes and his followers has been to prioritize the role of demand over supply in the economy. In the model proposed by Keynes, greater government expenditure causes aggregate demand to increase, leading to economic growth. In contrast, income-led growth theory leaves government expenditure out of the equation and proposes a different model in which economic growth is based on changes in capital in the private sector and the labor share. The basic argument is simple: members of the low-income group tend to spend more of their income, and members of the high-income group tend to save more of it. In short, the propensity to consume (spending as a percentage of income) is higher among the low-income group than among the high-income group. But as we have noted, capital income is concentrated in the high-income group, while the middle-income and low-income groups receive most of their income from labor. Therefore, decreasing the capital share and increasing the labor share of the national income would cause total spending to increase. To summarize, the model works as follows: increasing the labor share leads to more spending, raising aggregate demand and thereby causing economic growth.

This basic argument was developed some eighty years ago, but discussion of wage-led growth today is based on the model developed by Bhaduri and Marglin (1990). Under this model, aggregate demand in a country’s economy is composed of household spending (C), private-sector investment (I), net exports (NX, exports–imports), and government expenditure (G), represented by the formula aggregate demand=C+I+NX+G. This model assumes that government expenditure is neutral, or in other words that it does not change. So we will examine how a higher labor share affects the private sector—namely, spending (C), investment (I), and net exports (NX).

Spending is determined by household income. Labor income tends to represent a higher percentage of household income when total income is lower, and the propensity to consume also tends to be higher among low-income households. If the labor share rises, therefore, household spending will increase. An increase in spending resulting from a rise in the labor share could indirectly increase investment. In contrast, the decreasing rate of return on capital could cause investment to decrease. At the same time, a rise in the labor share causes companies’ labor cost to go up. That raises the relative cost of exported goods and lowers the relative cost of imported goods, exerting a negative effect on net exports.

To sum up, a rise in the labor share has a positive, negative, and neutral effect, respectively, on the individual components of aggregate demand. As a consequence, the ultimate effect on aggregate demand depends on the relative strength of each of those separate effects. Bhaduri and Marglin (1990) defined a wage-led demand regime as one in which a higher labor share brings about an increase in aggregate demand and a profit-led demand regime as one in which that brings about a decrease in aggregate demand.
Since a change in the labor share can theoretically have either a positive or a negative effect on aggregate demand, this becomes a matter for empirical research. Since Bhaduri and Marglin (1990), there have been a large number of empirical studies about which countries correspond to which demand regime, but their results have not been very satisfactory. The same countries in the same periods have been defined as wage-led demand regimes by some studies and as profit-led demand regimes by others, depending on the econometric models in use, the control variables, and the length of the time scale.

**Income-led Growth Theory and Productivity**

The standard income-led growth model only takes into account the demand side. But a rise in wages (that is, the labor share) affects not only demand but also supply (that is, productivity). If a rise in the labor share increases consumption, capacity utilization will rise, too, causing labor productivity to rise in turn. Furthermore, an increase in consumption promotes new investment, which also increases labor productivity. Another way in which rising wages can increase labor productivity is by promoting labor-saving facility investment or technological progress. If a rise in wages (and the labor share) increases labor productivity through these various channels, therefore, such effects need to be considered as well. That is to say, not only the increase in demand but also the improvement in productivity ought to be included in the effect on growth. There have also been quite a few empirical studies on this productivity effect; one of the best-known in Korea is by Hong Jang-pyo, who served as the first senior secretary for the economy in the Moon administration. Since Hong’s study played an important role in the Moon administration’s implementation of an income-led growth policy, we will examine its findings.

Drawing upon Korean data from the period 1981–2012, Hong, Jang-Pyo (2014) analyzed the effect that a rise in the labor share has on demand and productivity, or in other words on the demand and productivity regimes of the Korean economy. In his study, Hong analyzed labor income earned not only by wage workers but also by small business owners. His study came to the following conclusions about demand regimes. In the period prior to the Asian Financial Crisis (1981–1997), it found a very weak profit-led demand regime when small business owners were excluded and a weak income-led demand regime when they were included. During the period after the crisis (1998–2012), it found an income-led demand regime whether or not small business owners were included, though their inclusion implied a stronger income-led demand regime.

In terms of productivity regimes, Hong’s study found that the Korean economy not only exhibited Kaldor-Verdoorn’s law, according to which a rise in output improves labor productivity, but also that a rise in wages increases labor productivity even when controlling for output. According to this study, a rise in output’s effect on increasing labor productivity was greater after the crisis than beforehand, while a wage raise’s effect on increasing labor productivity was greater before the crisis than afterward.

When the ultimate effect of the labor share on economic growth was examined across all these demand and productivity regimes, a post-crisis rise in the labor share
was found to increase production, productivity, and employment. Based on these findings, Hong Jang-pyo (2014) drew the following conclusions about the characteristics of the Korean economy.

First, investment is hardly affected by corporate profitability but greatly affected by aggregate demand. A rise in real wages (the labor share) revitalizes the domestic market, increases capacity utilization, and promotes investment by improving labor productivity.

Second, an improvement in the labor share (that is, income distribution) does not weaken export competitiveness. This can be weakened in the short term, if rising labor income causes labor costs to rise, too. In the long term, however, export competitiveness is restored by the improvement in labor productivity resulting from higher labor income.

Third, since the 1997 Asian Financial Crisis, the Keynesian assumption that higher wages increase employment has been more suitable for the Korean economy than the free market assumption that higher wages decrease employment. Since the propensity to consume is greater for labor income than capital income, higher labor income could increase consumption—and that, in turn, could increase capacity utilization and trigger investment, culminating in higher employment.

Fourth, the effect that higher real wages and improved income distribution have on GDP, labor productivity, and the employment growth rate is greater when small business owners are included. The implication is that, in the Korean economy, increasing real income for the low-income group (including not only wage workers but also small business owners) is effective at spurring economic growth.

According to Hong’s diagnosis, as outlined above, the prescription for the Korean economy is obvious: increasing labor income, including the income of small business owners. Policy options that Hong has proposed for achieving that include raising the minimum wage, introducing a living wage, establishing a link between productivity and real wages, and stabilizing income for small business owners.

Assessment of Income-led Growth Theory

Issues Raised about Income-led Growth Theory in the Existing Literature

The Effect on an Open Economy

The Korean economy is highly dependent on foreign trade, which implies the importance of securing export competitiveness. If real wages are increased as proposed by income-led growth theory, some argue, costs would rise, which would reduce export competitiveness and thus have a negative effect on growth. But the theoretical model of income-led growth already discusses the effect on exports. Therefore, the claim that income-led growth theory does not apply to open economies represents a misunderstanding of the theory itself. But it should be noted
that the theory’s policy prescriptions may be less effective when implemented in a highly trade-dependent economy than in one focused on the domestic market.

**Validity as a Long-Term Growth Strategy**

Even mainstream economists who regard income-led growth theory as having some degree of potential as a strategy for economic growth see that as applying to the short term, but not the long term. Most economists acknowledge that a policy of expanding demand is a legitimate way to break out of an economic recession. But while it may be a response to short-term or mid-term business fluctuations, they say, that does not make it a strategy for long-term growth.

The dominant view in economic growth theory is that long-term growth requires improving productivity through innovation. To be sure, proponents of income-led growth theory counter by arguing that improving the labor share increases aggregate demand, which can increase labor productivity by raising capacity utilization and promoting investment. They argue further that there is another way in which higher wages have the effect of increasing labor productivity, namely by promoting labor-saving technological progress. While that is possible in theory, it is dubious how substantial those effects would be in reality.

Innovation is the source of the improvement in labor productivity that results from technological progress and investment. Furthermore, the engine driving innovation is the effort to innovate that is expended by innovative entrepreneurs (and inventors). In terms of incentives for eliciting such effort, the expectation that there is great profit to be made from innovation is probably much more effective than the need to reduce the costs resulting from higher wages. Furthermore, it is not so much increased demand per se that serves as the incentive for innovation as it is the expectation that increased demand will create more opportunities for making a profit. Just as wages are a workers’ compensation for labor, profit is the entrepreneur’s compensation for innovation.

**My View of the Debate about Income-led Growth Theory: Possible in Theory, but What About in Practice?**

The criticism of income-led growth theory in the existing literature focuses on theoretical issues. But the problems I have with income-led growth theory are less concerned with theory than with practice. What I am worried about is the policy lag and the endogeneity of decisions about the income share when the income-led growth strategy is put into practice. As I see it, the practical issues are more important than the theoretical ones.

**The Endogeneity of Decisions about the Income Share**

The labor share is generally determined endogenously. A boom in the economy causes an increase in the supply of labor, wages, and the income of small business owners; in a recession, the opposite occurs. Furthermore, such occurrences change
the labor share. To be sure, wage increases can also occur exogenously, when the minimum wage is raised or labor unions’ bargaining power is strengthened, but the greater part is probably determined endogenously.

Empirical studies of income-led growth theory rely on data from decades-long time series. In terms of changes in the labor share in the period being studied, the portion that occurs endogenously is probably greater than the portion that occurs exogenously. But adopting the prescriptions of income-led growth means that we implicitly regard the income share as being determined exogenously. Consequently, when empirical studies estimate the coefficient value that shows how changes in the income share affect growth, they commonly assume that the change in the income share is exogenous. But when one’s estimates are derived from data that has been determined endogenously, it does not seem valid to argue that one’s findings will be similar when they are determined exogenously.1

Even when Hong Jang-pyo (2014) found strong indications of income-led demand and productivity regimes in the Korean economy after the Asian Financial Crisis, he assumed that the labor share during the period being studied was determined exogenously. But during that period, the growth rate of the Korean economy was decreasing under the influence of globalization and structural changes; the economy was becoming more dependent on trade; and real wages were not rising as fast as labor productivity, causing the labor share to fall. As a result, the change in the labor share during this period was probably more endogenous than exogenous. When a coefficient value is calculated on the assumption that an exogenous change in the labor share occurred endogenously, that value cannot be assumed to remain the same when the labor share is altered through government policy (that is, exogenously).

The aggregate amount of labor income is found by multiplying price by amount (that is, the level of wages by the number of people participating in the labor market). For this reason, it is difficult to say how much the labor share will increase if wages are raised exogenously, especially if that substantially reduces employment or raises costs for small business owners (and thus reduces their income).2 Furthermore, even the effect of an exogenous increase in wages can vary depending on whether the wages being raised belong to the low-income group, through raising the minimum wage, or to the middle-income group, through strengthening labor unions’ bargaining power.3 Raising the minimum wage causes costs to rise for companies in the domestic service sector, and small businesses in particular. In contrast, raising wages by strengthening labor unions’ bargaining power typically raises costs for large corporations in the manufacturing sector. The effect on consumption and investment vary according to which group’s income rises and who has to cover the cost.

1 When drawing upon endogenously determined change in the income share to estimate the effect on employment and growth (that is, an exogenous effect), one is liable to commit the kind of model specification error described in econometrics. Such an error leads to bias in the estimated coefficients.
2 Since nearly all the labor income of small business owners is determined endogenously, this problem becomes more serious when we factor in not only wages but also small business owners’ labor income.
3 Blecker (2011) argued that an economy can become either income-led or profit-led, depending on what caused the change in the labor share.
Two implications can be drawn from the preceding discussion. First, we should be cautious about how we interpret the findings of empirical studies that estimate how an increase in the labor share affects growth. Second, even when implementing a policy aimed at increasing the labor share, we should be careful about which program we choose, since each program has a different effect on consumption, investment, and exports.

The Presence of a Time Lag

Pump-priming measures are an effective way to break out of a recession, which is why governments in a recession often resort to stimulus packages. That said, the policy of stimulating demand nearly always involves expanding the government’s fiscal expenditure. One would be hard-pressed to find an example of a government tackling a recession by attempting to change distribution in the private sector—through a minimum wage hike, for example. Fiscal expansion in a recession directly increases aggregate demand while having almost no effect, at least in the short term, on private-sector demand. That is why such measures definitely have the effect of stimulating demand. Changing distribution inside the private sector, on the other hand, not only has both a positive and negative effect on aggregate demand, but also exerts that effect indirectly. Therefore, even if the net effect on aggregate demand is positive under an income-led demand regime, that effect will take much longer to manifest than it would with government expenditure.

An Assessment of Income-led Growth Theory

Because of the endogenous way in which the labor share is determined and various other econometric difficulties, I am skeptical about the methodological validity of empirical studies that differentiate the economic regimes of various countries into income-led and profit-led. And I am not the only one; as Skott (2017) and others have observed, the methodological validity of these empirical studies is not yet widely acknowledged.

Even though I cannot be certain of the validity of the empirical findings that the Korean economy is characterized by strong income-led demand and productivity regimes, I believe that income-led growth theory is of great importance for the Korean economy today and that the policy prescriptions derived from that theory are indeed necessary. The reasons are evident: if the decrease in the labor share and the resulting polarization trend are allowed to continue, they will have a severely negative effect on the Korean economy.

Worsening Inequality Blocks Long-Term Growth

As we saw in Figure 2, the labor share in Korea has exhibited a definite decline since the Asian Financial Crisis. The profit share has been increasing, while the income (or wage) share has been decreasing. This trend is also evident in Figure 3,
below, which shows changes in the corporate share and the household (and non-profit) share of national income.

**Figure 3.** Changes in the household and corporate sectors’ share of the national income

(Left: household, right: corporate)

Note: National account from the Bank of Korea, gross primary income in each sector as a percentage of national income

Figure 3 shows that the household sector’s share of primary income increased while the corporate sector’s share decreased from the mid-1970s until the early 1980s. That reflects the rapid growth of corporations during Korea’s period of rapid economic development. But from the mid-1980s until the Asian Financial Crisis, the household and corporate shares remained fairly steady, with some minor fluctuations. The household share spiked as corporate profits plummeted during the crisis, but that was an exceptional situation.

More important for our purposes is the situation from the Asian Financial Crisis until the present. Even disregarding the tumultuous changes in 1998, in the middle of the crisis, there was a definite trend from the crisis until 2010 for the household share to decrease and the corporate share to increase. Since 2011, there has been some tendency for the household share to increase and the corporate share to decrease, but that rebound has been rather small, and it is too soon to tell whether that is temporary or whether it represents a turning point.

As I have already mentioned, the income distribution in the Korean economy has fallen since the Asian Financial Crisis while the gap between the rise in real wages and the improvement in labor productivity has increased. But it goes further

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4 While the government sector’s share exhibited a slow increase during the period in question, the scale of the change was not major (11% to 15%).
than that. Even inside the category of wages (or labor income), the gap between the high-income group and the low-income group has widened, as we will see in the following graph.

**Figure 4.** Comparing the degree of wage inequality in OECD member states (2014, full-time workers)

This graph shows the interdecile ratio (D9/D1), which is to say the factor by which wages at the ninetieth percentile (the top 10%) are greater than wages at the tenth percentile (the bottom 10%), assuming that wages are listed in ascending order. The data here shows that South Korea has the third highest wage inequality of the countries surveyed, after the United States and Israel.

The publication of French economist Thomas Piketty’s book *Capital in the Twenty-First Century* in 2014 was a sensation. The crux of Piketty’s argument was “r>g,” which is to say that the rate of return on capital is higher than the economic growth rate. According to Piketty, “r>g” causes the capital share to increase and the labor share to fall, leading to patrimonial capitalism, in which the rich get richer and the poor get poorer as wealth is inherited.\(^5\)

Should we allow the labor share to keep decreasing (and the capital share to keep increasing), making the rich richer and the poor poorer? Of course not. Worsening distribution is not only undesirable in terms of equity, but also has a negative effect on long-term growth. That is consistent with the observations that Nobel prize-winning economist Joseph Stiglitz makes about worsening inequality in American society in his 2013 book *The Price of Inequality:*

“We are paying a high price for our inequality—an economic system that is less stable and less efficient, with less growth, and a democracy that has been put into

\(^5\) Strictly speaking, capital as Piketty uses it is a broader term than capital in the sense of the means of production, but the argument holds even if we interpret it in that narrower sense.
peril. [...] As the reality sinks in that we are no longer a country of opportunity and that even our long-vaunted rule of law and system of justice have been compromised, even our sense of national identity may be put into jeopardy.”

In short, Stiglitz says, severe inequality causes social instability, which also has a negative impact on economic growth. To be sure, this argument is not grounded in an elaborate economic model or strict empirical analysis. It nevertheless strikes many people as reasonable, likely because it conforms to their lived experience. Many other scholars have made arguments similar to that of Stiglitz in countries around the world, including Korea. Even scholars who are not advocates of income-led growth theory agree that inequality is a severe issue that is hindering social unity and threatening steady economic growth, with numerous essays and books published on the topic. Considering that even conservative economic organizations like the International Monetary Fund and the World Bank have published study after study concluding that growing inequality is impeding economic growth, this can be effectively regarded as the consensus view.

To sum up, I think that increasing the labor share, the measure prescribed by income-led growth theory, is necessary for the long-term growth of the Korean economy. But that is not because Korea is an income-led economic regime; rather, it is because allowing the labor share to keep falling and distribution to keep worsening will undermine the foundation of our socio-economic system, which will have a negative effect on economic growth.

The Fairness of Contracts Must Be Guaranteed for the Market Economy to Operate Effectively

When the conditions for perfect competition are not in place in a market economy, the result is market failure, which is to say the inefficient distribution of resources. There are various reasons why market failure can occur, such as the economic participants not being on an equal footing. When economically active participants who are in a stronger position profit from their position, those in a weaker position suffer loss. The profit of the former is outweighed by the loss of the latter, which is why imperfect competition makes a market economy inefficient.

In principle, a market economy is run on contracts that participants enter into of their own free will. Such a contract is one that the contracting parties are free to reject if they so choose in favor of an alternative, implying that they are on an equal footing. Contracts that are concluded when the participants are not on an equal footing are unfair contracts, and a market economy that runs on unfair contracts is itself unfair. An equal footing for participants is the essence of fairness in the market economy, as well as being the condition for achieving efficiency therein.

One of the primary prescriptions of income-led growth theory is raising wages by boosting the bargaining power of labor unions. One of the reasons why wages are negotiated collectively, by a labor union, is that a wage contract between an individual worker and an employer cannot be concluded on an equal footing. Therefore, collective bargaining for wages by labor unions is a mechanism for

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guaranteeing the fairness of wage contracts. Raising the minimum wage is another mechanism for guaranteeing the fairness of contracts in the same context.

A policy of increasing fairness in the market economy by mitigating inequality between participants is needed not only in wage contracts but also in a variety of areas, including the relationship between contractors and subcontractors and the relationship between large corporations and SMEs. Furthermore, a policy of restoring fairness in these various areas would ultimately raise the labor share. For example, labor likely has a greater share of income relative to capital at subcontractors, as opposed to contractors, and at SMEs, as opposed to large corporations. Broadly speaking, therefore, a policy of increasing fairness in the market economy conforms entirely to the prescriptions of income-led growth theory. Such a policy would simultaneously serve to increase the efficiency of the market economy. When it comes to increasing the labor share and mitigating inequality in Korean society, I think that a policy of increasing the fairness of contracts in various areas is more important than a policy of raising wages directly.

Our Growth Strategy Needs to Include Not Only Improving Productivity But Also Stimulating Demand

According to the traditional view of economic growth, inadequate demand is a short-term phenomenon. In this view, a temporary expansion of government expenditure is recommended for boosting demand, while improving supply capacity (that is, productivity) is said to be important for long-term growth. It is obvious and indisputable that improving productivity through innovation is important for long-term growth. What is debatable, however, is whether inadequate demand is actually a short-term phenomenon. Perhaps that was a valid assumption during the manufacturing-centered industrial society of the past, but it is not in today’s economy. Because of labor-saving technological progress, labor’s share of manufacturing output has decreased while capital’s share has increased. Globalization has triggered a race to the bottom that has reduced labor’s share. Production capacity has continued to increase, but demand has not increased along with it. Excessive supply, or inadequate demand, has become a chronic issue.

I do not think that the fall in the labor share is the main cause of the chronic shortfall in demand.7 But it is obviously one of several causes. As such, I think that a policy of raising the labor share (or preventing its fall) is a necessary measure for counteracting that shortfall.

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7 What I regard as the most important cause of the demand shortfall is the lack of innovative products capable of creating new demand. Recall that it was Apple’s innovative product the iPhone that created the immense demand for smartphones and related products and services. My opinion may prioritize supply over demand. I address this topic in greater detail in Taeil Kim (2017)
The Role of Income-Led Growth Theory in the Korean Economy Moving Forward

An Assessment of Income-led Growth Theory

While income-led growth is regarded as the Moon administration’s signature strategy for growth, it was only one of four policy directions outlined when Moon announced his strategy for growth in July 2017, at the beginning of his presidency, alongside a job-focused economy, innovative growth, and a fair economy. But only income-led growth came into focus, while the other three policy directions were ignored. There are two likely reasons for that. First, income-led growth was an unfamiliar concept based on a theory that is not widely accepted by mainstream economists, while the other three policy directions had also been emphasized by previous administrations and were generally thought to be necessary for the growth of the Korean economy. But an even more important reason was that the chief prescription for income-led growth, raising the minimum wage, provoked controversy in society, while the prescriptions for the other three policy directions were less tangible.

It was appropriate for the Moon administration to select a job-focused economy, innovative growth, and a fair economy alongside income-led growth as the four directions for its growth strategy. More disappointing, however, was its understanding of the role that income-led growth was supposed to play in its growth strategy. Initially, the Moon administration appears to have regarded income-led growth as a short-term stimulus for the domestic economy. As such, it expected that a 16.4% raise in the minimum wage would bring about economic growth by stimulating demand without decreasing jobs.8

One of the basic assumptions in traditional economic theory is that a rise in prices (in this case, wages) causes a fall in demand (in this case, employment). To be sure, there are also empirical studies that have found that raising the minimum wage has a negligible effect on reducing employment or even causes it to increase. But those studies focused on rather exceptional situations, and it is sensible to predict that a minimum wage hike will have a negative effect on employment, at least in the short term.9 So while the government should have predicted the side effects of raising the minimum wage and taken measures to minimize its side effects while maximizing its benefits, it failed to do so.

8 In November 2017, for example, Minister of Economy and Finance and Deputy Prime Minister Kim Dong-yeon said, “Increasing the household income of low-income workers will boost spending, aiding growth, while more investment in the human capital of disadvantaged groups could also augment our growth potential in the medium to long term.” This quotation appeared in an article on Yonhap News on November 9th, 2017.
9 Some of the best-known empirical studies suggesting that a minimum wage hike can be positive for employment are by American economist David Card. But because his studies either focus on a strong economy (Card, 1992) or capital-intensive large franchises like McDonald’s (Card & Krueger, 1994), it would be best not to overgeneralize. For a thorough discussion, see Kim & Taylor (1995) and Aaronson et al. (2018).
In other words, the prescriptions of income-led growth theory are not designed to deal with short-term economic issues or to create growth directly. Rather, they are designed to lay the foundation for the market economy to play its original role and to achieve fairness in the market economy. Just as a fair economy is not a method for directly driving economic growth, neither are the prescriptions of income-led growth theory.

**Income-Led Growth Theory and the Future Direction of the Korean Economy**

What then is the future role of income-led growth theory in the Korean economy? Furthermore, if the arguments of income-led growth theory remain valid, how should we go about putting them into practice? I intend to provide two distinct answers to these questions. The first will summarize more clearly the points that have come up in this discussion. The second will offer a new proposal based on the implications of those points.

**Summing Up the Current Discussion**

If we review the meaning and role of income-led growth theory as discussed above, it is possible to arrive at the following two implications.

First, it is clear that the aim of income-led growth is to lay the foundation for long-term growth, and it must be pursued consistently with that long-term goal in mind. Since we cannot expect short-term results, effecting gradual but steady change while minimizing side effects is preferred to radical change.

Second, it is also important to take measures to increase the fairness of contracts in a variety of areas, including wage contracts. After raising the minimum wage, the government imposed regulations on rental fees, credit card fees, and the profits collected by the head offices of franchises in an attempt to ease the burden of labor costs on small business owners. These regulations were necessary, but they were not intended to mitigate the side effects of raising the minimum wage. These are three classic examples of areas in which the fairness of contract is not protected because the contracting parties are not on an equal footing. In short, the regulations were designed to establish fairness in the market economy, which helps increase the labor share and reduce inequality. Of course, these regulatory policies are not short-term prescriptions either, so once again it is appropriate to seek gradual but steady change while minimizing side effects, from a long-term perspective.

**Additional Proposals**

The labor share should be monitored as an indicator for the medium- and long-term growth strategy and managed accordingly. If the argument of income-led growth theory were boiled down to a single prescription, that prescription would be increasing the labor share (or preventing its decrease). Such a measure would be necessary even if we do not accept the
argument of income-led growth theory. A decline in the labor share exacerbates inequality, which erodes the foundation of our socio-economic system. Moving forward, therefore, we should define the labor share as one of the indicators that we manage when planning our economic strategy, just as we monitor and manage indicators such as the economic growth rate, the level of government debt, and the Gini coefficient.

A large portion of the labor share is determined endogenously. There are few feasible methods of raising the labor share directly (that is, exogenously) aside from a minimum wage hike. And since raising the minimum wage can also reduce employment or decrease the labor income of small business owners, there is no way to predict what its ultimate effect on the labor share will be. So while we ought to continue to move forward prudently with exogenous policies such as raising the minimum wage, it is also important to craft policies for increasing the labor share indirectly, which is to say exogenously. As I have already mentioned, various policies for increasing the fairness of contracts double as policies for increasing the labor share.

As I noted earlier, labor income can be calculated by multiplying price by amount. Managing labor income, therefore, demands that we manage its sub-indicators, such as the number of workers, the level of their wages, and the income of small business owners. We must also pay attention to the institutions and the policy measures that can affect those sub-indicators. In short, this requires first setting up a comprehensive program for managing the labor share and then setting goals and following through on them.

In my opinion, monitoring and managing the labor share in this manner is the most effective way to apply income-led growth theory to the Korean economy, as well as being the most faithful to its aims.

**Welfare expenditure needs to be expanded.**

Income-led growth theory has always focused entirely on the private sector while disregarding the government sector. That is why it proposes increasing the labor share in the private sector as a way to increase demand. In short, its argument runs as follows: increasing the labor share will lead to more spending, which will increase demand and therefore income.

Income-led growth theory is a product of post-Keynesian economics, which carries on the Keynesian tradition of emphasizing the demand side of the economy. When the economy slows because of inadequate demand in the private sector, Keynes said, government expenditure should be expanded in order to increase demand. In short, Keynes’ chief interest was having the government spend more to boost demand. But income-led growth theory emphasizes increasing demand and

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10 Although strengthening the bargaining power of labor unions or enacting a living wage can be regarded as policies for increasing labor income, the effects of such policies would be very limited given the actual conditions of the Korean economy.

11 Of course, Keynes also paid adequate attention to the importance of private-sector demand. For example, he warned that falling wages could reduce consumption, which could lead to an economic slowdown.
consumption in the private sector, an increase that is achieved through a change in distribution.

Income-led growth theory’s emphasis on increasing consumption by changing distribution derives from the economic conditions that were in place when this theory emerged. During the mid-twentieth century, the industrial societies of the West were enjoying the golden age of welfare capitalism. Government fiscal policy that lined up with Keynesian prescriptions served to effectively regulate the economy. Government welfare expenditure continued to increase, taking up a substantial amount of households’ disposable income. During this period, the labor share was held at a steady level as well.¹²

Circumstances began to change toward the end of the twentieth century as the world moved into the post-industrial society and the age of globalization. The economic growth rate decreased, and greater welfare expenditure caused government debt to balloon and became a fiscal burden. The labor share gradually fell, with a resulting increase in inequality. Amid technological progress, productivity kept increasing until the capacity for supply outstripped demand.

Because governments were already saddled with heavy debt and their expenditure accounted for a large share of GDP, they were unable to expand fiscal expenditure to deal with the shortage of demand, which was not due to a temporary business cycle but was rather the chronic result of supply capacity exceeding demand. For the same reasons, those governments could not expand welfare expenditure, despite intensifying inequality. This led some to argue that demand should be stimulated by increasing labor income in the private sector.¹³

The situation in Korea is different from that in the West. Welfare expenditure as a percentage of the Korean budget is less than half of that in Western countries. That has led to something of a consensus about the need to expand welfare expenditure (though there is a debate about the amount and method of that expansion).

Generally speaking, welfare expenditure benefits the low-income group more than the high-income group. Inversely, more of the funding for welfare expenditure comes from the high-income group than from the low-income group. Therefore, welfare expenditure increases the disposable income of the low-income group and reduces that of the high-income group. So if the Korean economy is indeed a wage-led demand regime, as posited by income-led growth theory, expanding welfare expenditure will expand aggregate demand.¹⁴

¹² These characteristics of Western industrial societies in the mid-twentieth century are also known as the Keynes-Ford-Beveridge compromise (Boyer, 1990).

¹³ While this is not explicitly stated by income-led growth theory, increasing the labor share by definition means mitigating income inequality. The reason that raising the labor share increases spending is because it means increasing the income of the low-income group and decreasing the income of the high-income group, thus alleviating income inequality. Because the low-income group has a higher propensity to consume than the high-income group, this has the effect of boosting consumption.

¹⁴ One study linking income-led growth theory to welfare expansion in this way is Lavoie and Stockhammer (2013). Defining the postwar Western capitalist states as wage-led economic regimes, these scholars contend that it was their adoption of a pro-labor distribution policy that ushered in the golden age of capitalism. While I have my doubts as to whether the postwar Western capitalist states were actually wage-led economic regimes, I do agree that expanding welfare expenditure would increase aggregate demand in a wage-led economic regime.
While I have not run an analysis employing an elaborate econometric model, I agree that the Korean economy is a wage-led demand regime. Therefore, I am willing to entertain the validity of the argument that expanding welfare expenditure will lead to an increase of aggregate demand, which will in turn increase income. But that is not why I think it is necessary to expand welfare expenditure.

On a structural level, polarization is becoming more severe in post-industrial society, and this is being exacerbated by globalization. Such structural changes in the economy have had a major impact on the decline of the labor share in the advanced capitalist states since the last few decades of the twentieth century and in the Korean economy since the 1990s. That is why managing the labor share (as I proposed above) will only go so far if such efforts are limited to market income. It is also necessary to manage disposable income, including government taxation and transfer payments, and to reduce inequality in disposable income. That is, we need to both mitigate inequality in market income by restoring fairness to the market economy and also mitigate inequality in disposable income by expanding welfare expenditure.

In industrial societies, when the labor share was maintained at a certain level (or when there was a low level of wage inequality), there was little need to mitigate inequality through welfare expenditure. During that period, it was enough to guarantee income for those who had lost their market income (such as the retired and the unemployed). But in post-industrial society, it has become important not only to protect from the risk of income loss, but also to guarantee the income of low-income workers. While cash payments are the primary method of guaranteeing income, an important part of supplementing the income of low-income workers is paying for services such as medical care, childcare, and education. Expanding payments for such services reduces the amount of services that these individuals must pay for with their own income, allowing them to spend more in other areas.

In the fall of 2017, Ozlem Onaran and Engelbert Stockhammer, two of the leading scholars on income-led growth theory, held a symposium in Korea. During that symposium, the two scholars emphasized that increasing the share of labor income in the market and expanding the government’s investment in society (through higher spending on education, public health, and welfare) are important prescriptions for income-led growth. I agree with their position.

The role of each aspect of our growth strategy needs to be clarified.

I have previously argued that our strategy for achieving economic growth should be focused on innovation and grounded in fair competition, a social safety net, and investment in human capital. But something else is needed to facilitate innovation: adequate compensation. The compensation for successful innovation must be sufficient to create more of an incentive to innovate. The greater the

15 I have neatly summarized the related discussion in Taeil Kim (2017).
16 At the same time, expanding payment for services such as childcare replaces work that was once done unofficially in the home with official employment, with the effect of creating jobs.
compensation, the greater the effort put into innovation, as long as the amount of compensation does not run counter to social norms.

Of course, the question of how much compensation is appropriate is open to debate. But what I want to emphasize here is that, for an economy to be highly innovative, successful innovators must be given adequate compensation, and the resulting inequality of market income should not be seen as negative. Inequality resulting from innovation differs from inequality resulting from rent-seeking behavior and other forms of unfair competition. In response, we should not reduce compensation, but expand public investment in human capital in order to reduce inequality at the starting line, and we should guarantee fair competition in order to create more opportunities for participating in innovation. Furthermore, we should set up a social safety net to guarantee a certain degree of income to those who have fallen behind and help them get back on their feet. As this suggests, we need to clarify the roles to be played by the three aspects of this growth strategy (namely, a fair economy involving income-led growth, a social safety net based on expanded welfare, and greater investment in human capital) and to ensure that each of those aspects are fulfilling their roles.

Over a decade ago, Nobel prize-winning economist Robert Lucas said, “Of the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution.” But he was wrong. It is no longer possible to discuss economic growth without considering questions of distribution. Whatever may be said about income-led growth, it is clear that we need a strategy for growth that leads to income.

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