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Inclusive growth - A primer for a supply-side concept

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Abstract

The aim of the concept of inclusive growth, which is being promoted in particular by international organisations such as the OECD, is to derive political recommendations on the basis of selected indicators so that a maximum number of socio-economic groups may benefit from the economic progress of a country. On the one hand, this initiative continues the long-running debate on alternative welfare measures beyond GDP per capita. On the other, the discussion on the relationship between growth and distribution is being revitalised. This article deals with the potentials and limitations of the concept of inclusive growth. In principle, it would be welcomed to pay more attention to the distribution aspects of economic growth. However, conventional inclusive growth concepts bear a number of shortcomings: they are theoretically weak, institution-blind, not embedded within a growth context, and normatively shaped. The indicators used focus on results or outcome rather than on growth drivers. In addition, outcome variables are mixed with supply-side indicators. Therefore, the conventional concepts should be further developed into an institution-oriented "inclusive growth accounting" with a focus on the growth factors of labour, education and capital.

1 A new dimension in the distribution debate

The debate on the advantages and disadvantages of economic growth has been one dimension richer for some time now. In addition to sustainability, i.e. the environmental and resource compatibility of growth, the question is increasingly being asked whether all groups in a society can benefit appropriately from economic growth. Political developments in many countries accompanied by a strengthening of populist positions in recent years have given additional impetus to the question as to who are the winners and losers of economic development (World Bank, 2018). However, the analysis of the distributional effects of growth is not new; it has always been part of the debate on the various consequences of economic development (Kuznets, 1955).

The concept of inclusive growth questions whether and how different population groups participate in economic development. According to the Organisation for Economic Co-operation and Development (OECD), inclusive growth is an economic development that creates opportunities for all socio-economic groups of the population and is able to distribute the monetary and non-monetary result of the growth process fairly across society (OECD, 2014a; 2014b). In essence, the analysis of inclusive growth is ultimately about whether, and to what extent, economic development can go hand in hand with an improvement in the quality of life of all population groups.

There are currently a number of analyses of how inclusive growth can not only be interpreted and defined, but also measured (OECD, 2014b). These approaches are based on the manifold efforts and proposals to measure welfare in an economy. Above all, the report by Stiglitz, Sen and Fitoussi (2009) has given new impetus to the question as to the most appropriate method for measuring and evaluating welfare. An expanded concept of welfare goes far beyond per capita income commonly used. Distribution and sustainability targets beyond gross domestic product (GDP) are explicitly included in the analysis, and policy measures can be formulated accordingly.

An early OECD approach (Boarini et al., 2015) was based on measuring the multidimensional living standards of different population groups. Indicators for the three dimensions of income, work and health were used. The aim is to measure whether certain population groups could improve their position with regard to these indicators or not.

Table 1-1: OECD Concept for Measuring Inclusive Growth

Category	Core indicator	
1. Growth and ensuring equitable sharing of benefits from growth	1.1	GDP per capita growth (%)
	1.2	Median income growth and level (%; USD PPP)
	1.3	S80/20 share of income (ratio)
	1.4	Bottom 40 % wealth share and top 10 % wealth share (% of household net wealth)
	1.5	Life expectancy (number of years)
	1.6	Mortality from outdoor air pollution (deaths per million inhabitants)
	1.7	Relative poverty rate (%)
2. Inclusive and well-functioning markets	2.1	Annual labour productivity growth an level (%; USD PPP)
	2.2	Employment-to-population ratio (%)
	2.3	Earnings dispersion (inter-decile ratio)
	2.4	Female wage gap (%)
	2.5	Involuntary part-time employment (%)
	2.6	Digital access (businesses using cloud computing services) (%)
	2.7	Share of SME loans in total business loans (%)
3. Equal opportunities and foundations of future prosperity	3.1	Variation in science performance explained by students' socio-economic status (%)
	3.2	Correlation of earnings outcomes across generations (coefficient)
	3.3	Childcare enrolment rate (children aged 0-2) (%)
	3.4	Young people neither in employment nor in education & training (18-24) (%)
	3.5	Share of adults who score below Level 1 in both literacy and numeracy (%)
	3.6	Regional life expectancy gap (% difference)
	3.7	Resilient students (%)
4. Governance	4.1	Confidence in government (%)
	4.2	Voter turnout (%)
	4.3	Female political participation (%)

Source: OECD, 2018, p. 27

A further approach of the OECD (2018) is based on a number of different previous works and initiatives. Table 1-1 shows the four categories of the measurement dashboard:

1. Growth and the ensuring equitable sharing of benefits from growth
2. Inclusive and well-functioning markets
3. Equal opportunities and foundations for future prosperity
4. Governance

A total of 24 indicators have been defined for these four categories, all based on internationally comparable statistics regularly compiled by the OECD. The background for the OECD's various measurement approaches to inclusive growth is partly formed by the recommendations of the Stiglitz/Sen/Fitoussi Commission (Stiglitz et al., 2009) and the OECD's analyses of welfare and distribution based on said recommendations (2011a; 2011b). The OECD approach to inclusive growth can therefore be placed within the context of a distribution analysis. This is evident from a number of indicators: S80/S20 share of income, bottom 40 percent and top 10 percent wealth share, relative poverty rate, earnings dispersion, female wage gap, and correlation of earnings outcomes across generations.

The fact that the concept of inclusive growth has now also entered the political agenda is visible, for example, in the ten-point plan for inclusive growth published by the German Federal Ministry of Economics and Technology (BMWi, 2017) during the 2017 election campaign in Germany. This represented a first prominent derivation of the rather academic debate for the political agenda setting of a German government. This first concrete reception of the concept of inclusive growth also revealed the normative arbitrariness with which the theoretical concept is interpreted in political practice. Ten sections of the plan discussed deficits in the achievement of important political goals and potential countermeasures. While at the target level - e.g. priority for investment, good framework conditions for innovation, digital strategy 2025, high employment level with better wages - an understanding is probably possible even with different economic policy positions, there are strikingly different views on the selection and interpretation of the indicators used, and even more so on the derivation of political recommendations.

2 Outline of an alternative concept

Approaches for measuring welfare and inclusive growth usually start with the outcomes of the growth process, so that result variables such as GDP and indicators of income distribution (e.g. income shares by decile, median income, earnings spread) are in the foreground. This encompasses two conceptual difficulties: on the one hand, the question of whether growth is inclusive is primarily answered by the result or outcome of macroeconomic activity. This presupposes a normative guideline for assessing a certain income distribution resulting from the production process. This, in turn, raises questions as to what qualifies as socially fair or equitable distribution, the level at which an existing degree of personal inequality is considered unfair, or indeed how regional differences in distribution are to be assessed.

In addition to these normative problems in assessing economic growth and the associated distribution of income, a number of measurement concepts for inclusive growth do not distinguish between outcome indicators and those indicators that contribute to, or allow for, certain results. Thus, indicators such as investment, education, employment and political freedom can be understood as outcome measures of economic growth on the one hand, but also as determinants of growth on the other. Even if such a distinction is made conceptually in the respective measurement approach, the two dimensions overlap again in an overall assessment. This leaves open, however, which indicators are ultimately to be regarded as important and which as less important, how the individual facts can be compared and whether they are at all accessible for an integrated assessment (Brümmerhoff/Grömling, 2015, 335).

Focus on income generation: The following explanations (see Grömling/Klös, 2018) allow for a change of perspective towards an "inclusive production function". Here, the focus is exclusively on which institutions influence or determine the outcomes of the economic process. Such a

concept starts with the growth process and the associated income generation. By focusing on the supply side, one can avoid making a normative assessment of the income distribution and the evaluation of the fairness of results.

Above all, the observed commingling of outcome indicators and process or supply-side indicators to measure inclusive growth should be avoided. The analytical separation of outcome indicators on the one hand, and the determinants of the outcome on the other, has already been addressed in a number of studies (e.g. Ali/Son, 2007; Klasen, 2010; Benner/Pastor, 2016). While the OECD approach is aimed at fairness of outcomes and a corresponding improvement of the situation of individual population groups, such an approach explicitly calls for the results orientation to be supplemented by a process orientation. Accordingly, all population groups should be able to contribute to the growth process – partly with an explicit focus on obviously less well-included groups. The supply side is central to this understanding of inclusive growth.

Focus on opportunities: According to our definition, inclusive growth is about creating opportunities and access to broader participation in economic life. In this context, one can refer to the "capability" approach put forward by Sen (2010, 253 ff.). Accordingly, a person's welfare depends on his chances. These are largely determined by political freedoms and social opportunities such as education and health. Roemer and Trannoy (2016) provide a comprehensive overview of the many theoretical concepts for analysing and measuring equality of opportunity. Ali and Son (2007) have developed a social opportunity function in the context of inclusive growth to measure the distribution of opportunities within a society. This process orientation is also clearly reflected in the proposal and measurement approach of the Rockefeller Foundation (Benner/Pastor, 2016). However, a clear separation of outcome and process indicators is not implemented here either.

Focus on institutions: From an institutional-economic perspective, the extent of inclusive growth depends crucially on whether the institutions relevant for economic development have an inclusive effect and whether all members of society can therefore contribute to economic life to the same degree or to an extent perceived as subjectively sufficient, and thus to income generation. Since technical progress and structural change can also devalue human capital and thus reduce the employability of those affected, the design of labour market and educational institutions, for example, is of decisive importance for whether and how well (re-)integration into employment and economic life can succeed.

This basic idea can also be found in the institutional-economic development approach proposed by Acemoglu/Robinson (2013). The presence of inclusive growth is synonymous with the availability of inclusive economic institutions. The assessment and underlying measurement of inclusive growth at the level of income generation is ultimately about looking at and evaluating the

openness of the central economic markets to different population groups. The growth process can qualify as inclusive if society as a whole can participate in the generation of income. In other words, growth is not inclusive if members of society are restricted in their participation in the economic process and their ability to generate income is thus impaired. Such an institutional-economic approach should therefore be understood within the context of equal opportunities and not against a backdrop of fair results.

Focus on growth theory: Another criticism of conventional sets of social indicators is that they are not based on an economic theory. Instead, they are mostly pure data collections without a systematic theoretical reference (Brümmerhoff/Grömling, 2015, 335). The approach pursued here, on the other hand, is based on growth theory or on a macroeconomic production function. As a further step, a growth function can explicitly be extended by further independent variables (e.g. institutions, regulations) to a so-called "inclusive growth accounting".

3 Pinpointed impact analysis

Inclusive institutions can increase growth and the associated macroeconomic income, but this is not always the case. The correlation between the inclusive quality of institutions and growth performance must always be transmitted via the dependent variables. Ultimately, this interdependence can only be answered empirically. Consequently, an empirical impact analysis would have to be carried out for each of the relevant institutions, showing the microeconomic and macroeconomic consequences of introducing or varying individual institutional or regulatory parameters.

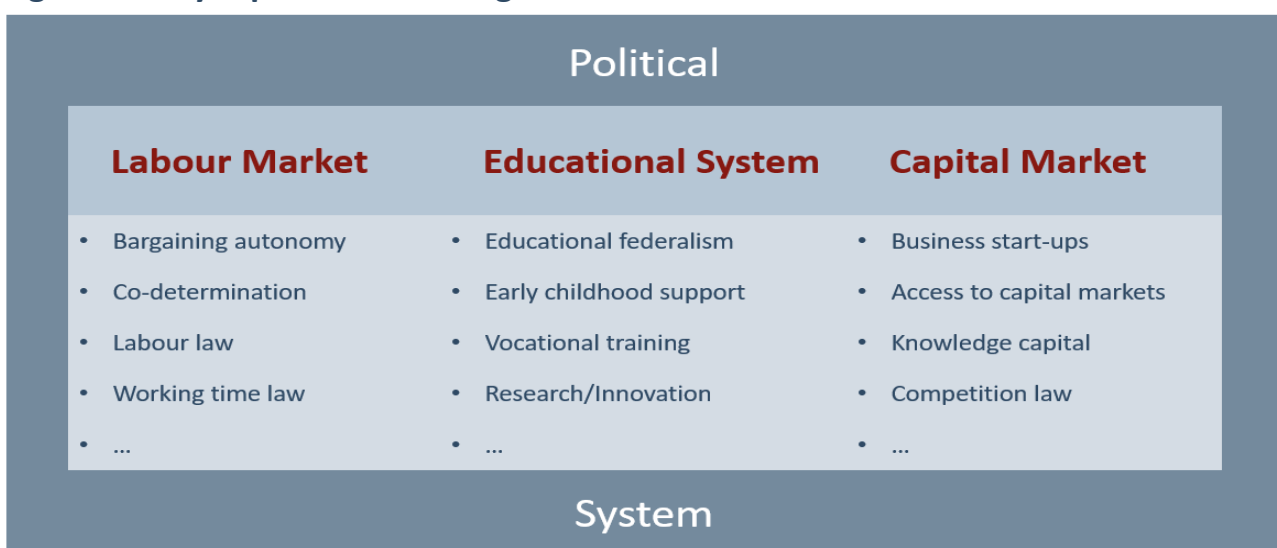
When selecting the relevant institutions, a fundamental distinction should be made between the direct effects of inclusive institutions on the one hand, and their indirect effects on growth, distribution and welfare on the other, in order to avoid the commingling with outcome indicators being criticised here. One example would be regulations aimed at facilitating work-life balance: in this case, women's participation in the labour market would be facilitated. The direct effect of such inclusive institutions would be a higher employment rate for women. However, a higher labour force participation rate itself is not a direct indicator for the inclusiveness of an institution, but is already an outcome indicator. The corresponding welfare effect would then become visible in income levels and income distribution by gender. Accordingly, numerous other labour, education and capital market institutions initially lead to direct effects on participation rates by age, gender or origin and indirectly to welfare effects, visible for example in the level and distribution of income by age, gender, region and origin. However, this analytical differentiation is not made in conventional indicator systems.

Finally, when discussing the relationship between individual institutions and individual outcome variables, one must assess whether the basically inclusive institutions actually have an inclusive effect. Attention must be paid to potential trade-offs that can make a basically inclusive institution, i.e. a law or an administrative regulation, exclusive in the sense that they have a restrictive effect on access and lead to insider-outsider effects. For example, pronounced employment protection can lead to a higher level of shelter for the employees benefiting from it (insiders), and at the same time impair companies' propensity to hire as a result of higher labour costs. This weakens the income earning potential of the existing unemployed or those who are newly unemployed because of the higher labour costs (outsiders). In this case, an institution meant to be inclusive ultimately acts as a labour market barrier and is thus exclusive. Whether and to what extent such trade-offs become effective is a question that can only be answered empirically on a case-by-case basis.

4 Central economic markets

If one pursues the basic idea that inclusive institutions can be both drivers of growth as well as determinants of its outcomes, then the next step is to look at individual growth factors and the institutions central to them. If growth theory is taken as a starting point and theoretical foundation, then it is essentially a matter of labour input, education and human capital stock, physical capital stock and technical knowledge. This in turn forms the theoretical and conceptual reference to "growth accounting". Specific factor markets can be defined for each of these growth factors. In addition, the political system or the quality of political institutions is also included in the analysis. Figure 4-1 portrays the relevant economic markets and some selected institutions.

Figure 4-1: Synopsis of selected growth-relevant institutions



Source: Grömliing/Klös, 2018, p. 18

In contrast to existing indicator systems for measuring and evaluating inclusive growth, the supply-oriented approach proposed here assesses the openness of access to these central factor markets and to the political system, and thus the opportunities for participation of individual population groups in economic income generation (for a comprehensive analysis see Grömling/Klös, 2018). The institutions responsible for the openness of these markets are therefore conceptually relevant for the analysis, measurement and evaluation of inclusive growth.

4.1 Labour market institutions

One of the most important determinants of economic growth and participation in an economic system is the labour market. In a conventional "growth accounting", labour input is the most important factor in overall economic activity. From a macroeconomic point of view, labour income dominates income generation (Grömling, 2017). Participation in economic life through gainful employment, combined with the opportunity to climb the income ladder by entering the labour market, is a central anchor of legitimacy for market economies. Youth unemployment, and long-term unemployment in particular, represent serious burdens for social cohesion in societies. At the same time, they signal an economic waste of growth and income opportunities.

The labour market situation in a country is the result of a multitude of intervening variables and institutions. These central institutions have grown historically, and together determine employment conditions and the volume of employment. Important institutions of the labour market are, for example (especially with regard to Germany):

- **Wage autonomy:** There are central interrelationships between the specific wage-finding systems, for example with their respective links to regional collective agreements, and important labour market indicators - employment, remuneration, working conditions - which are also important in the assessment of inclusive growth (ILO/OECD, 2018).
- **Co-determination:** Company co-determination regulates, for example, the working conditions in the respective companies. This raises the question of whether and how this institution can be interpreted and evaluated as inclusive.
- **Labour law:** This regulates, for example, protection against dismissal and fixed-term rules. Here, too, the effects on macroeconomic employment and income are decisive. Labour law does not have an inclusive effect, for example, if it is accompanied by insider-outsider problems because it develops into a labour market barrier for certain groups.
- **Working time law:** Internationalisation and digitisation can make greater working time flexibility necessary at company level. Legal regulations that oppose this may create barriers to entry and hamper more inclusive growth.

4.2 Institutions of the education system

Human capital describes the qualitative dimension of labour, i.e. the knowledge and professional skills of the labour force. Investment in human capital, i.e. better education and qualification of workers, can increase productivity and income levels. With regard to the inclusiveness of growth, this means that access to the education system in an economy must be as open as possible. If, on the other hand, there are barriers to access for certain socio-economic groups in the education system, individuals will have limited options for income generation. Here, institutions must be defined that are relevant for equal opportunities in human capital formation. Essentially, it is about equal starting opportunity, which can be justified both from a perspective of justice and from a decidedly economic perspective. With regard to an analysis of inclusive growth, institutions in the following areas of education can be cited:

- Educational federalism: Here, for example, one can examine whether there are relevant regional educational differences at different federal levels as a result of regional institutional decisions.
- Early support: Early childhood education has a major influence on labour market opportunities and upward mobility. Individual groups such as single parents and families with a migration background may deserve special attention on this front.
- Vocational education and training: Countries differ considerably in terms of vocational training, vertical permeability in the education system and upward mobility. The design of vocational education and training thus has an impact on the employment opportunities of different population groups, also and especially on the employment and income effects as a result of progressive digitisation.
- Research and development: Innovation policy, for example, influences which regions and which population groups can participate in the so-called "digital revolution" (Bienert et al., 2018). Access to digital infrastructure and digital competence will be important institutional decisions for the future that will also influence the employment and income paths of different population groups (Korinek/Stiglitz, 2017).

4.3 Capital market institutions

In general, the capital stock relevant for growth includes buildings, machinery, equipment and intellectual property (e.g. the results of research and development). The entrepreneurial capital stock is an essential determinant of the production level of an economy, and thus a source of income and welfare. In addition, the government provides public buildings and infrastructure (e.g. transport networks). Lastly, technical knowledge plays a decisive role in growth and welfare. In this context, it is particularly relevant how open the access to new knowledge is.

Accordingly, within the framework of an inclusive growth approach, one must also examine whether there are access restrictions for certain socio-economic groups or companies to a broadly understood capital market. In concrete terms, this means whether different groups of a society have adequate opportunities for capital formation, whether the financial markets are equally open for the financing of investments and whether the economic opportunities of digitisation and the generation and use of the associated intangible capital are broadly usable. The question is whether the different socio-economic groups or types of enterprises participate in the corresponding capital formation and can thus also generate the associated capital income, or whether there is only limited competition here, which ultimately leads to market power and corresponding income concentration. The guiding principle for forward-looking considerations is the hypothesis that the growth and distribution effects of technological change, with its extensive digitisation in almost all economic and social areas and the rapid advance of applications of artificial intelligence (AI), depend on how broad sections of the population succeed in participating in this development and how the emergence of a "digital divide" can be prevented (Bertelsmann, 2017; Bienert et al. 2018).

Against this backdrop, the following considerations can be drawn about the design of the relevant institutions:

- **Business start-ups:** Within the context of inclusive growth, it is advisable to analyse which groups of people found business start-ups and whether there are group-specific barriers.
- **Capital market access:** The World Bank has set up a database for more than 140 countries to measure financial inclusion. Applied to the concept of inclusive growth, the access of different socio-economic groups to financial services can be examined.
- **Access to knowledge capital:** So-called intangibles are gaining importance for economic growth. Accordingly, with regard to this production factor, one can also examine whether property rights are neutrally defined and guaranteed or whether there is concentration and corresponding market power.
- **Competition law:** In principle, this should counteract a concentration of power and monopolisation. Furthermore, it needs to be clarified whether and to what extent digitisation already poses new challenges to competition law today.

4.4 Political Institutions

Long-term growth is directly determined by the production factors mentioned above. However, the general framework conditions that affect the functioning of the market system and the social security system in an economy also contribute to economic development. Political participation also plays an important role. According to Acemoglu and Robinson (2013), the quality of economic institutions determines economic results. Political institutions in turn determine

whether there are any good economic institutions at all. The state as a constitutional state defines property rights, assigns them to individuals and guarantees them. Only the guarantee of property rights provides incentives for individuals and corporations to accumulate production factors and use them in the production process. Against this backdrop, political institutions must also be taken into account in the analysis of inclusive growth.

The political dimension depends on whether in a society a broad participation of all sections of the population in the formation of political will and decision-making ("public choice") is guaranteed, or whether political power is concentrated within certain groups or an elite. It is also a question of whether political decisions are controlled by a freely elected and representative parliament. Last but not least, the question arises as to whether an independent judiciary exists to enforce law and order neutrally. In this context, the concept of social capital also plays a role, such as trust in government and administration, or the civic engagement of society (Scrivens/Smith, 2013). Political institutions are inclusive if the members of a society are involved in political decision-making and control regardless of age, gender, origin, religion or region. Inclusive political institutions have an intrinsic value for the functioning of civil society and the people's understanding of the state, and thus also influence economic processes, such as investments in production factors, and thus production and income in a country (La Porta et al., 2008).

5 Limits and potentials of concepts of inclusive growth

The concept of inclusive growth, developed and promoted by international organisations, is becoming more and more relevant for both international and national policy-making. The fundamental idea that the formulation of economic policy goals should pursue other goals in addition to increasing per capita income and that special attention should be paid to ensuring that all groups of the population benefit to an adequate extent from general growth has now become firmly established in national policy agendas. There is widespread agreement that distribution issues should occupy a firm place in analyses of the welfare effects of economic development.

Based on most conventional indicators, Germany can currently be assessed as inclusive when it comes to the participation of broad groups of the population in the outcomes of the growth process (Schmid, 2018). On the basis of outcome indicators - which are indispensable for welfare assessment - Germany performs well. Key distribution indicators, such as income inequality, returned to former levels in the stronger growth years since 2005.

However, there is widespread scepticism about the potential consequences of digitisation, which will motivate forward-looking political action. The basic idea of inclusive growth will gain

further relevance as a consequence of rapid technological developments, because there is concern that gains from innovations will not benefit all population groups ("the winner takes it all") and that the majority of the technically less-educated population will experience fears of a loss of control.

In our opinion, the concept of inclusive growth requires further conceptual development along the following lines in order to gain greater acceptance in concrete policymaking:

1. The previous inclusive growth concept has so far been too normative, and theoretically weak. It primarily gathers indicators that are based on value judgements. The growth context is not established in the selection of indicators. The target indicators used are outcome indicators, not independent determinants of growth. However, policy cannot have a direct impact on results, but can at best use the target-means relationships between certain parameter changes in individual growth factors and the results of the growth process.
2. What is therefore required is a concept for a production function to achieve inclusive growth in which, by varying growth-relevant institutions, broad groups of the population can participate as much as possible in economic activities and thereby in macroeconomic income generation. This is a change of perspective compared to the conventional approach and requires the identification of growth-determining factors and the relevant institutional set-up.
3. Another shortcoming of the conventional approach is the neglect of complementarities or substitutional effects for individual variables. For example, institutional changes making fixed-term employment more difficult can block access to the labour market for certain groups of people. A measure meant to be inclusive can thus prove to be exclusive. In addition, certain measures in individual policy areas can mitigate, neutralise or reinforce the effects of measures in other areas.
4. The conventional approach bears a number of shortcomings in terms of content and empiricism. In view of rapid technological developments due to digitisation and artificial intelligence, participation in economic development will depend more than ever on access to knowledge and capital, basic technical and infrastructural equipment, and stable political conditions such as data and cyber security. All these points play almost no role in the current debate on inclusive growth. This makes it all the more important to consistently promote the development of human capital in a digitalised economy. This must be taken into account – for example in the form of certain educational formats – in an analysis and measurement concept.
5. Furthermore, the question arises as to the extent to which the interpretation and analysis of inclusive growth presented here can also be implemented empirically. The analytical concept outlined here is accompanied by a strong supply-side focus in comparison with other approaches for measuring inclusive growth. A central goal should be to avoid a commingling of process-oriented and outcome-oriented indicators. This allows for

stronger analytical clarity and a focus on institutions that are relevant for ensuring that the members of society are involved as comprehensively as possible in the generation of income.

6. Lastly, an empirical implementation of this approach is not yet possible or only possible to a very limited extent. This is also due to the fact that relevant data for specific socio-economic groups is not available. Limitations in economic interpretation also arise when the focus is solely on the measurability of facts or the existence of available indicators. It is therefore possible that measurements are being made not of what should be measured, but instead only of what can be measured or has already been measured.

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