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Income inequality and the business cycle: A threshold cointegration approach

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ABSTRACT

This paper investigates the impact of various socio-economic variables on various cohorts of the income distribution. We use asymmetric cointegration tests to show that unemployment and immigration shocks have real impacts on income inequality. In addition, using threshold test results we are able to show that positive and negative shocks to the economy do not have symmetric effects nor do the impacts of these shocks impact income quintiles uniformly.

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1. Introduction

Beginning with the seminal work of Kuznets (1955) many researchers have endeavored to investigate the nature of the relationship between economic growth and income inequality. The Kuznets hypothesis posited that the functional relationship between inequality and economic development had an inverted “U” shape. Kuznets speculated that inequality would initially be positively correlated with economic development but that the relationship between economic growth and inequality would become negative at higher levels of development. Results supporting this hypothesis typically come from the use of cross-sectional country-specific data. Some recent researchers dispute the Kuznets hypothesis such as Bruno et al. (1998). Still others, such as Blinder and

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Esaki (1978), have found results that support the basic premise of the Kuznets hypothesis but expand on how inflation and unemployment factor into inequality.

What makes this area of research so inviting is that key to the debate over the relationship between growth and inequality is the question of what impact growth has on citizens throughout the entire income distribution. Most research in this area investigates the impact that economic development, namely GDP, has on some standard measure of income inequality, such as the Gini coefficient. What cannot be gleaned from these endeavors is whether a growing economy is helping all segments of society or is just helping certain subsets of society.

If economic growth is found to be positively correlated with income inequality it is not clear if the increase in income inequality is being caused by an increase in the incomes of those in the highest quintile of the income distribution while those in the bottom quintile have incomes that are stagnant or falling. It could also be the case that while incomes are growing for all income quintiles, the income growth of the top quintile is greater than the income growth for other quintiles. These are empirical questions that cannot be answered by simply regressing a standard Gini coefficient against GDP.

Our paper will go beyond what has been done previously in that we will be able to investigate the various degrees of impact that economic growth, unemployment, and to a lesser extent, immigration have on different cohorts of the income distribution. This paper has the advantage of using a time series that has nearly 60 years of reliable U.S. data. Specifically, we consider whether economic upturns have a different impact on income inequality than economic downturns.

Asymmetric behavior over the business cycle has attracted considerable attention in the last decades. Neftci (1984) showed that several measures of U.S. unemployment display asymmetric adjustment over the course of the business cycle. Focusing on the asymmetric behavior of unemployment rates over the business cycle, Rothman (1991) showed that the primary source of asymmetry is the cyclical behavior of the unemployment rate in the manufacturing sector. Acemoglu and Scott (1994) have also shown asymmetries in the cyclical behavior of UK labor markets. Harris and Silverstone (2001) and Silvapulle et al. (2004) tested asymmetric adjustment in specifications of Okun's law. They found that the short-run effects of positive cyclical output on cyclical unemployment are quantitatively different from those of negative ones; as such, the relationship between labor market indicators and aggregate income is asymmetric.

1.1. *Previous research and our model*

Typically there have been two approaches to this type of research. One approach uses a cross-section of countries with varying levels of economic growth and income inequality to investigate the impact of economic growth on country level inequality. Another approach is to take a consistent time series for one country (typically the United States) to analyze how growth over time has impacted income inequality without regard to redistributive policy measures such as taxes or social programs. What we propose in this paper is more akin to the latter methodology.

Our model is similar to that of Blinder and Esaki (1978) and Bishop et al. (1994) with some key differences. Both papers use an extensive time series, although the one used in our paper is the longest, by far, and covers the period from 1948 to 2003. (See Perman and Stern (2003) for an excellent review of the issues and techniques related to this type of investigation.) Blinder and Esaki (1978) used income quintiles as left hand side variables with a time series of unemployment and inflation as explanatory variables. Their finding that inflation is progressive along the income distribution has been supported others such as Blank and Blinder (1986).

Later work by Bishop et al. (1994) includes several controls for demographic, structural, and economic variables that might also affect movements along the income distribution. They also recognized that the possibility of random walks and cointegration should be addressed. The time series they used is relatively short and they did not include a measure of income inequality, such as the Gini coefficient to test the validity of the Kuznets hypothesis.

Research, such as that done by Chen (2003), Gomez and Foot (2002), and Adams (2003), does test the Kuznets hypothesis with fairly reliable country-level cross-sectional data. Their results are complementary to Kuznets but fail to account for the variance in responses of the different quintiles along the income distribution. Income is being impacted by growth in their model but they cannot say

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