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Asia's quest for inclusive growth revisited☆

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ABSTRACT

Despite the rapid economic growth and poverty reduction, inequality in Asia worsened during the last two decades. We focus on the determinants of growth inclusiveness and suggest options for reform. A cross-country empirical analysis suggests that fiscal redistribution, monetary policy aimed at macro stability, and structural reforms to stimulate trade, reduce unemployment and increase productivity are important determinants of inclusive growth. The main policy implication of our analysis is that there is still room to strengthen such policies in Asia to better achieve growth with shared prosperity. In particular, scenario simulations based on our results suggests that the effect of expanding fiscal redistribution on inclusive growth could be sizeable in emerging Asia, since the estimated improvement in our proxy of inclusive growth—a measure of growth in average income "corrected" for the equity impact—ranges from about 1% to about 8% points.

1. Introduction

Inequality has increased in the last decades in both advanced and developing economies as a result of various factors, including globalization and technological change. At the same time, there is a growing international consensus that economic inequality is bad for both growth and social cohesion, and that policies should play an important role to facilitate inclusive growth, or growth accompanied by an improvement in equality.

High inequality can dampen growth through various mechanisms, including by decreasing the purchasing power of a large part of the population, demotivating the average worker and leading to decreased performance and workforce attachment, and through diminished access to health and education.

An empirical analysis by OECD (2014), for example, concluded that the long-term trend increase in income inequality has curbed economic growth significantly in its member countries. In particular, the analysis by OECD (2014) presents evidence that by hindering human capital accumulation income inequality undermines education opportunities for disadvantaged individuals, lowering social mobility and hampering skills development.

Against this background, the United Nations' Report on the World Social Situation 2013 emphasized that addressing inequalities is not only a moral imperative but it is also necessary in order to unleash the human and productive potential of

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each country's population and to bring development toward a socially sustainable path. Similarly, recent World Economic Forum's Global Risks (WEFGR) reports argue that the widening gaps between the richest and poorest citizens threaten social and political stability as well as economic development.

Responding to the WEFGR analysis, International Monetary Fund's managing director Christine Lagarde said that "Excessive inequality is corrosive to growth" (Speech at Davos, Switzerland, January 23, 2013).[1] The WEFGR findings and Lagarde's comments are clear examples of how the international consensus is shifting from the past belief that there is a trade-off between economic growth and equality (e.g. Okun, 1975) to a new conventional wisdom in which ensuring equality is seen as critical for sustainable growth.

Other examples of this new conventional wisdom can also be found in the work of Berg and Ostry (2011), who document, using a multi-decade and multi-country analysis, how greater equality can help sustain growth.[2] The relationship between inequality and growth also has implication for poverty reduction. According to several authors, equality strengthens the poverty-reducing effect of growth. Son and Kakwani (2003), for example, use a theoretical framework to show that the impact of growth on poverty reduction is lower when inequality is high. Similarly, Grammy and Assane (2006) carry out an empirical analysis using data for over sixty developing countries, finding that growth accompanied by improved distribution works better than either growth or distribution alone in reducing poverty.

As Berg, Ostry, and Tsangarides (2014) stress, the fact that equality seems to drive higher and sustainable growth does not in itself support redistribution, since inequality may impede growth at least in part because it calls forth efforts to redistribute that themselves undercut growth, as higher taxes and subsidies dampen incentives to work and invest. While the latter was the assumption underpinning the analysis by Okun (1975), more recent contributions have also recognized that redistribution need not be inherently detrimental for growth. In some theoretical models, redistribution can increase both equality and growth, as progressive taxes finance public investment and social insurance spending enhances the welfare of the poor as well as risk-taking (Benabou, 2000), and higher health and education spending help offset labor and capital market imperfection (Saint-Paul & Verdier, 1993, 1997). Empirically, Lindert (2004), finds that some categories of public spending which reduce inequality (such as health, education and infrastructure spending) have no apparent adverse impact on growth, while Berg et al. (2014), conclude that the combined direct and indirect effects of income redistribution are on average "pro-growth".

The debate on the relationship between inequality, redistribution, poverty reduction and growth is particularly relevant for Asia, since, as stressed by Zhuang, Kanbur, and Rhee (2014), although poverty reduction in developing Asia over the past two decades has happened faster than in any other region of the world, at any other time in recorded history, the bulk of the region's population still lives in countries with rising inequality. Furthermore, Balakrishman, Steinberg, and Syed (2013), point out that the more recent period of growth in Asia has been less inclusive and less pro-poor, compared to both other regions and Asia's own past. This discussion suggests that there is scope for policy measures to broaden the benefits of growth in Asia. In this context, several recent papers, including Berg et al. (2014) and Bastagli, Coady, and Gupta (2012) have focused on how fiscal policy can be used to reduce inequality through redistribution, promoting both economic efficiency and equity. Within the specific context of Asia, Zhuang et al. (2014) have argued that, in addition to efficient fiscal policy, measures to address regional disparity and to make growth more employment friendly are also needed to reduce inequality, while Balakrishman et al. (2013) have stressed the importance of fostering financial inclusion.

In this paper, we revisit the issue of Asia's quest for inclusive growth. Our analysis includes both a descriptive part, in which we review recent trends and stylized facts on poverty and inequality, and a cross-country empirical analysis of the determinants of inclusive growth. For the latter, we regress the measure of inclusive growth developed by Anand, Mishra, and Peiris (2013) on various determinants. Compared to previous papers which have used this approach (e.g. Anand et al., 2013; Balakrishman et al., 2013), we explicitly include in our model a variable which proxies the impact of fiscal redistribution, as well as variables which seek to gauge the inequality impact of monetary policy.

The reason for which we focus on both the pace and distribution of economic growth, rather than simply focusing on inequality trends, is that, compared to traditional measures of inequality, our measure of inclusive growth can more adequately capture cases in which an increase in inequality is more than compensated by average income growth, so that the overall effect on average welfare is still positive, despite an increase in inequality.

Our cross-country empirical analysis suggests that fiscal redistribution, monetary policy aimed at macro stability, and structural reforms to stimulate trade, reduce unemployment and increase productivity are important determinants of inclusive growth. The main policy implication of our analysis is that there is still room to strengthen such policies in Asia to better achieve growth with shared prosperity. In particular, scenario simulations based on our results suggests that the effect of expanding fiscal redistribution on inclusive growth could be sizeable in emerging Asia, since the estimated improvement in our measure of inclusive growth ranges from about 1% to about 8% points.

The structure of the paper is as follows. Section 2 presents some trends and stylized facts regarding poverty, equality and inclusive growth in Asia. Section 3 reviews the literature on policies for inclusive growth. Section 4 presents some empirical

[1] "A New Global Economy for a New Generation" speech by Christine Lagarde, Managing Director, International Monetary Fund, Davos, Switzerland, January 23, 2013. Available at: https://www.imf.org/external/np/speeches/2013/012313.htm.

[2] While one could argue that a modest degree of inequality could have a beneficial effect in providing incentives to improve performance, the recent empirical literature on the relationship between inequality and growth does not support this view.