IMF Working Papers 15/42

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INTERNATIONAL MONETARY FUND

WP/15/42

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Asia and Pacific Department

# Asia's Quest for Inclusive Growth Revisited

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Authorized for distribution by Odd Per Brekk

February 2015



**Abstract**

Despite the rapid economic growth and poverty reduction, inequality in Asia worsened during 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 percentage points.

JEL Classification Numbers: F43; D63; H23; O11

Keywords: Inclusive growth; Asia; inequality; economic growth

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[1] We thank for comments Odd Per Brekk, Romain Duval, Sanjeev Gupta, Siddharth Kothari and Jonathan Ostry. All opinions and remaining errors are ours.

## I. 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.

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 each country's population and to bring development towards 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).[2] 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. 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.

Other examples of this new conventional wisdom can also been 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. 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, Gramy 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 supports 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 dumpen 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

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

taxes finance public investment and social insurance spending enchances 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 and 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, Ostry and Tsangardies (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, Balakrishnan et al. (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, Ostry, and Tsangarides (2014) and Bastagli et al. (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, Kanbur and Rhee (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 Balakrishnan 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 et al. (2013) on various determinants. Compared to previous papers which have used this approach (e.g. Anand et al. (2013) and Balakrishnan 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.

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 percentage points.

The structure of the paper is as follows. Section II presents some trends and stylized facts regarding poverty, equality and inclusive growth in Asia. Section III reviews the literature on policies for inclusive growth. Section IV presents some empirical evidence based on a panel of countries, which is consistent with the findings by previous studies that fiscal transfers, prudent monetary policy, and efficient structural reform could improve inclusive growth. Section V discusses effort and progress made towards inclusive growth in some Asian countries so far and provides some policy recommendations. Section VI concludes.

## II. Inclusive Growth in Asia: Trends and Stylized Facts

Inclusive growth is a multidimensional and complex concept and there is no consensus in the literature and in policy discussions on how it should be defined and measured. One possible approach is to define growth as inclusive if people in the lower income brackets benefit from economic growth equally or more than the population as a whole. As an example of this point of view, Beegle et. al. (2014) discuss the recent shift in the World Bank's mission to focusing on promotion of shared prosperity, in addition to its traditional focus of ending extreme poverty (measured as then number of people living with less than USD 1.25 a day).[3] Beegle et al. (2014) stress that the new goal of promoting shared prosperity should be achieved by boosting the incomes of the poorest 40 percent of the population in every country. In operational terms, this would mean that the World Bank will need to add 1.3 billion people to its target population. In many countries, this will include individuals who are not poor in absolute term (i.e. they live with more than $1.25 per day), but can still be considered as "relative poor" in their countries.

Other authors, on the other hand, have argued that inclusive growth should be "disadvantage-reducing" growth. Klasen (2010) for example, defined inclusive growth as growth that mainly benefits disadvantaged groups, i.e. growth that reduces regional, ethnic, and gender disparities.

Similarly to the example discussed above, the inclusive growth concept that we use in this paper is broader than definitions which focus only on reducing absolute poverty. Our definition and measure of inclusive growth refers to both the pace and distribution of economic growth. In particular, in the descriptive part presented in this section, we present a comparison of country-specific income distribution indifference curves over time. Such comparison allows us to capture both growth and equity. In the same vein, the proxy that we use in our empirical analysis in next section, developed by Anand et al. (2013), is an attempt to capture inclusive growth by accounting for both changes in growth and in income distribution. Before focusing on these measures of inclusive growth, we provide an overview of trends in poverty and inequality in Asia. These show how, despite rapid economic growth and poverty reduction, inequality has increased during the last two decades.

### A. Poverty

Poverty has fallen in recent decades in Asia. While this is part of a world-wide trend, the East Asia and Pacific region has experienced the most dramatic reduction of poverty—measured

[3] See also http://blogs.worldbank.org/developmenttalk/poverty-shared-prosperity-and-trade-offs

as the percentage of the population living below certain poverty lines (see panel chart below). Asia's poverty reduction trend was most remarkable at the absolute poverty level, measured as a poverty line of $1.25-$2.50 a day at 2005 international prices. Using the strictest definition ($ 1.25), East Asia and the Pacific experienced the fastest decline in the world, followed by South Asia. Furthermore, such decline has happened in a steady way since the early 1980s. If we look at moderate poverty levels ($4.00-$5.00), a significant reduction in East Asia and the Pacific becomes evident since the early 1990s, at a pace comparable with that observed in Latin America and Europe and Central Asia (although the reduction in East Asia and the Pacific happened from higher levels of moderate poverty).

China alone accounted for most of Asia's decline in extreme poverty over the past decade. Between 1990 and 2010, the nation had about 530 million people moving out of extreme poverty. By comparison, during the same period, the rest of the developing world saw a reduction of poverty of 170 million. The remarkable reduction in poverty achieved by China implies that the share of population living on less than $1.25 a day in China went down to 12% in 2009, from more than 60% in early 1990s. China's experience may be cited as a counter-argument to the need for curbing inequalities in order to reduce poverty, since the dramatic declines in poverty discussed above have been achieved in a context of high growth and rising inequality. However, some authors have argued that, without rising inequality, China's high growth would have translated into even higher poverty reduction (see for example Fosu (2011)).

While China accounts for the bulk of poverty reduction in Asia, all other Asian countries that have sufficient data available also show significant progress since the early 1990s (text chart). Extreme poverty reduction was remarkable in Vietnam, where the percentage of the population living on less than $1.25 per day dropped from 64 percent in 1993 to 17 percent in 2008. Indonesia also saw the extreme poverty rate dropping from 54 percent to 16 percent, and Cambodia from 45 percent to 19 percent. The drop in poverty in The Philippines was less marked, but this is mostly because the country started from lower (31 percent) extreme poverty rates in the early 1990s. Thailand and Malaysia have managed to reduce extreme poverty virtually to zero. Overall, all the countries included in the text chart have extreme poverty rates below 20 percent, with the exception of Lao PDR.