Asia's Quest for Inclusive Growth Revisited

Policy Options for Economic Growth & Income Equality

By Chie Aoyagi & Giovanni Ganelli

Concepts of Inclusive Growth

The consensus in the economics profession is shifting from the past belief that there is a trade-off between economic growth and equality — as proposed by Arthur M. Okun in *Equality and Efficiency: The Big Tradeoff* (Washington, 1975) — to a new conventional wisdom in which ensuring equality is seen as critical for sustainable growth. The relationship between inequality and growth also has implications for poverty reduction, as equality seems to strengthen the poverty-reducing effect of growth. This has led to a new concept of "inclusive growth".

However, "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, Kathleen Beegle and others 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 the number of people living on less than $1.25 a day ("Ending Extreme Poverty and Promoting Shared Prosperity: Could There Be Tradeoffs Between These Two Goals?", *Inequality in Focus*, Vol. 3, No. 1, World Bank Group, 2014). Beegle et al. stress that the new goal of promoting shared prosperity should be achieved by boosting the incomes of the poorest 40% of the population in every country.

Other authors, on the other hand, have argued that inclusive growth should be "disadvantage-reducing" growth. Stephen Klasen, for example, defined inclusive growth as growth that mainly benefits disadvantaged groups, i.e. growth that reduces regional, ethnic, and gender disparities ("Measuring and Monitoring Inclusive Growth: Multiple Definitions, Open Questions, and Some Constructive Proposals", *ADB Sustainable Development Working Paper Series No. 12,* 2010).

Similarly to the example discussed above, the inclusive growth concept that we use in this article 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.

Debate on Inclusive Growth in Asia

The debate on inclusive growth is particularly relevant for Asia, because 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, 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 implies that there is scope for policy measures to broaden the benefits of growth in Asia.

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In this context, several recent papers, including those by Andrew Berg, Jonathan Ostry and Charalambos G. Tsangarides ("Redistribution, Inequality, and Growth", *IMF Staff Discussion Notes No. 14/2,* 2014) and Francesca Bastagli, David Coady and Sanjeev Gupta ("Income Inequality and Fiscal Policy", *IMF Staff Discussion Notes No. 12/8,* 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, Juzhong Zhuang, Ravi Kanbur and Changyong Rhee ("Rising Inequality in Asia and Policy Implications", *ADB Working Paper No. 463,* 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 Ravi Balakrishnan, Chad Steinberg and Murtaza Syed have stressed the importance of fostering financial inclusion ("The Elusive Quest for Inclusive Growth: Growth, Poverty, and Inequality in Asia", *IMF Working Paper No. 13/152,* 2013).

1. Trends & Stylized Facts

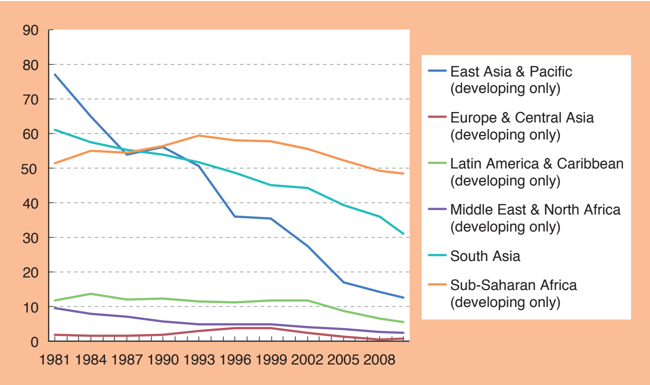
Poverty

Poverty has fallen in recent decades in Asia. While this is part of a worldwide trend, the East Asia and Pacific region has experienced the most dramatic reduction of poverty — measured as the percentage of the population living below a certain poverty line. 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. Furthermore, such decline has happened in a steady way since the early 1980s. 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). Using the strictest definition ($1.25 poverty line), East Asia and the Pacific experienced the fastest poverty decline in the world, followed by South Asia *(Chart 1)*.

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

CHART 1

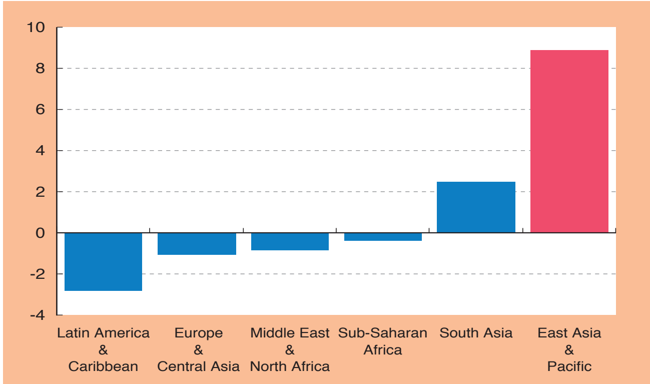
Poverty headcount ratio at $1.25 a day (PPP) (% of population)



Sources: The World Bank, Poverty and Inequality Database

CHART 2

Developing countries: change in Gini Index since early 1990s (population-weighted, in Gini points)



Sources: The World Bank, Poverty and Inequality Database; Authors' Calculations

million people moving out of extreme poverty. By comparison, during the same period, the rest of the developing world saw a reduction in 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 the 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, without rising inequality, China's high growth could have translated into even higher poverty reduction.

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. Extreme poverty reduction was remarkable in Vietnam, where the percentage of the population living on less than $1.25 per day dropped from 64% in 1993 to 17% in 2008. Indonesia also saw the extreme poverty rate dropping from 54% in 1990 to 16% in 2011, and Cambodia from 45% in 1994 to 19% in 2009. The drop in poverty in the Philippines was less marked, from 31% in 1991 to 18% in 2009, but this is mostly because the country started from lower extreme poverty rates in the early 1990s. Thailand and Malaysia have managed to reduce extreme poverty virtually to zero from 12% in 1990 and from 2% in 1992 respectively. Overall, almost all the Asian countries that have sufficient data available have reduced extreme poverty rates to below 20%.

Despite the sharp decline in poverty experienced by Asia, 251 million people were still living in extreme poverty in East Asia and the Pacific as of 2010, accounting for about 20% of the world's extreme poor. Moreover, the $1.25 per day measure used by the World Bank may not fully capture the extent of extreme poverty in the region. According to the Asian Development Bank in 2014, if three other factors — the cost of consumption specific to Asia's poor; food costs that rise faster than the general price level; and vulnerability to natural disasters, climate change, economic crises, and other shocks — are considered, Asia's estimated extreme poverty rate would be as high as 41% in 2015 and it would fall only to about 17% by 2030, even with the assumption that current growth trend continues.

Equality

Despite remarkable growth and impressive declines in extreme poverty, inequality has increased in Asia over the past few decades. Regional aggregate data on inequality are not readily available, but using available country-level data on the World Bank database, we calculated a population weighted average of the Gini Index, the most widely used index for measuring income inequality, which ranges from 0 (perfect equality) to 100 (complete inequality: one person has all the income or consumption while all others have none). According to the calculations, the population weighted average of the Gini Index for developing countries in East Asia and the Pacific increased on average by about 9 percentage points since the early 1990s *(Chart 2)*. In contrast, the same indicator for developing countries in most other regions, except South Asia, has decreased.

As a consequence, our measure of inequality, the aggregate Gini Index, in developing East Asia and the Pacific currently is around 41, getting closer to the one observed in Sub-Saharan Africa (44) and Latin America (51) and higher than one observed in other developing regions in the world (Europe and Central Asia (33), South Asia (33), and Middle East and North Africa (33)).

Looking at individual Asian countries' Gini Index, income inequality increased in China (from 32 in 1990 to 42 in 2009), Indonesia (from 29 in 1990 to 38 in 2011), and Laos (from 30 in 1992 to 37 in 2008), while marginally decreasing or remaining stable in Malaysia (from 48 in 1992 to 46 in 2009), the Philippines (from 44 in 1991 to 43 in 2009), Cambodia (from 38 in 1994 to 36 in 2009) and Vietnam (stable at 36 between 1993 and 2008). Overall, while China alone accounted for a 7.8 percentage point change in the population weighted Gini Index for East Asia and the Pacific mentioned above, other countries also did not improve equality sufficiently to reverse the regional aggregate trend.

The most recent data available for Malaysia, the Philippines, and China (2009) show that they still have high inequality, with Gini Indexes of 46, 43, and 42 respectively. Even in Thailand, the only country which managed to achieve a somewhat more significant decline in inequality (as its Gini Index fell from 45 in 1990 to 39 in 2010), inequality has been still high. Furthermore, in emerging Asia and the Pacific, income tends to be concentrated unevenly at the top of the distribution ladder. The income share held by the richest 10% of the population ranges from 28% in Vietnam to 35% in Fiji, which is higher than the OECD average of 25%.

Growth Inclusiveness

The evidence presented so far has emphasized that inequality has increased in Asia despite considerable success in poverty reduction. As we stressed at the beginning, this is problematic for at least two reasons: 1) inequality is bad for growth, and 2) the gains, in terms of poverty reduction, could have been stronger had growth been more equitable. It is thus important to focus on inclusive growth, a concept which, in our interpretation, refers to both the pace and distribution of economic growth.

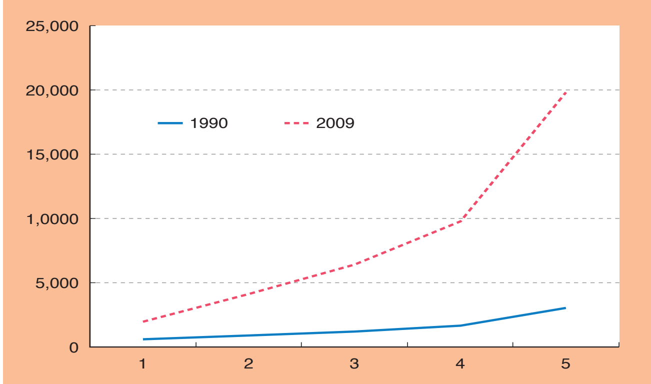
One way to assess the degree of inclusive growth of a country is to use indifference curves in which the horizontal axis shows the population arranged in ascending order of income (with the leftmost being the bottom 20% and rightmost the top 20%) and the y-axis shows the mean income of each corresponding income group. Since a higher curve implies higher average income, we can define growth as inclusive if the curve moves upward at all points. However, the degree of inclusive growth varies depending on: (i) how much the curve moves up (growth); and (ii) how the distribution of income, or the steepness of the curve, changes (equity).

For example, we can see China's rapid growth has benefitted society unevenly, as the indifference curve become much steeper over time *(Chart 3)*. In other words, China's "inclusive growth" was driven by growth rather than by improvements in equality. Compared to China, growth in other Asian countries, especially Thailand and the Philippines, seems to have been shared relatively more equally across income groups, though in most countries (with the exception of Fiji and, to a lesser extent, the Philippines), incomes at the very top increased much more than at other levels. These findings suggest that, although at varying degrees, an uneven growth trend is common among Asian countries, and there is room to improve growth inclusiveness by achieving a more equal distribution of income.

CHART 3

Indifference Curves for China

(GDP per capita, PPP (constant 2011 international $))



Sources: The World Bank, Poverty and Inequality Database; Authors' calculations

2. Determinants of Inclusive Growth

In light of the discussion above, we can conclude that despite the rapid economic growth and poverty reduction, inequality in Asia worsened during last two decades. In a recent study ("Asia's Quest for Inclusive Growth Revisited" by Chie Aoyagi and Giovanni Ganelli, *IMF Working Paper,* 2015) we looked in detail at the determinants of inclusive growth, and suggested some policy options for Asia.

The 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 this 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 the empirical 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, while the panel's mean of inclusive growth index is 3.7 percentage points.

3. Inclusive Growth Policies in Asia

Fiscal Policy

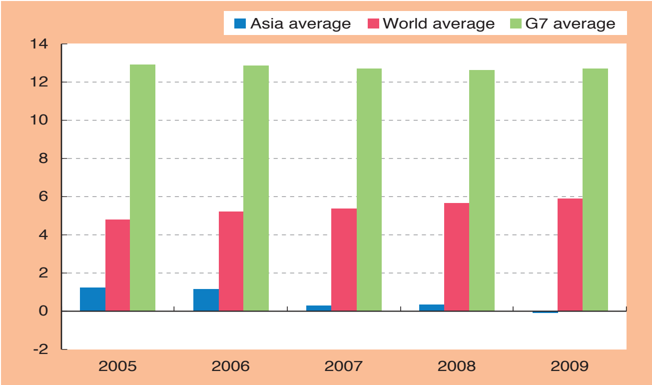
In Asia, policymakers have traditionally used macroeconomic policy primarily to support growth, rather than to redistribute income. However, growing concerns about rising inequality are prompting a major rethink, and many governments in the region are responding to the recent rise in inequality by developing medium-term development plans to make growth more inclusive. Examples of such development plans are: Cambodia — "Growth, employment, equity and efficiency" (2009-2013); the Philippines — "Pursuit of inclusive growth" (2011-2016); Thailand — "A happy society with equity, fairness and resilience under the philosophy of a Sufficiency Economy" (2012-2016); China — "Rebalancing the economy, ameliorating social inequality and protecting the environment" (2011-2015); and India — "Faster, more inclusive and sustainable growth" (2012-2017). Indonesia (2010-2014) also offers a vision supported by inclusive and fair development, and Malaysia (2011-2015) adopts an inclusive development approach, aiming at improving the livelihood of the poorer 40% of households.

Conditional cash transfer (CCT) programs are being increasingly used in emerging economies, such as Brazil and Mexico, and considered as being successful. For example, the Philippines introduced a CCT program in 2008 to help redirect resources toward socially desirable programs in a well-targeted way. As of June 2013, the program covered almost 4 million households. The empirical results of our study mentioned above are good news for such efforts, since they suggest that policies can be successful in pursuing equality and growth at the same time. Despite ongoing efforts, fiscal redistribution in Asia — measured by the relative difference between the Gini coefficient of market income and that of disposable income — remains way below the world average and levels observed in G7 countries *(Chart 4)*.

In practice, the effects of different redistributive fiscal policies on inequality and growth differ, and it could well be the case that some redistributive fiscal instruments might hurt growth. Thus it is very important for countries to adopt the redistributive fiscal policy instruments with the least negative efficiency impact. In its board paper "Fiscal Policy and Income Inequality" (2014), the IMF provides a menu of policy options — which can help achieve redistributive goals in an efficient manner. The policies suggested by the IMF, which would need to be examined and applied selectively on a country-specific base, include: using means-tested and conditioned cash transfer programs; conditioning eligibility for benefits on participation in active labor market policies; making income (including pension income) taxation and benefit cuts progressive; greater use of in-work benefits, designing

CHART 4

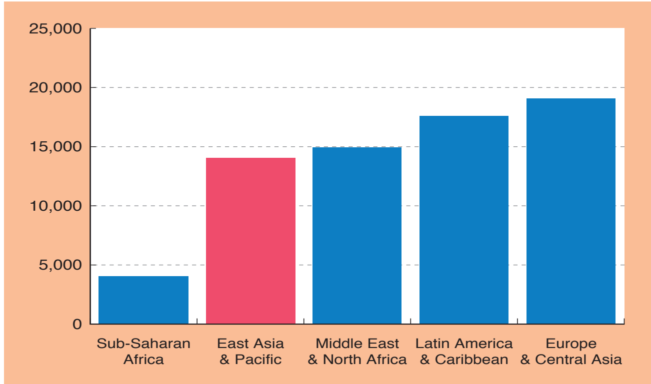
Redistribution (Gini coefficient points)



Sources: SWIID 4.0, Authors' Calculations
(Asia includes China, Cambodia, Indonesia, Malaysia, Philippines, Thailand, and Vietnam)

CHART 5

Developing countries: productivity 2012
(GDP per person employed; constant 1990 PPP $)



Sources: The World Bank, World Development Indicators

unemployment benefits in a way that strengthens incentives to take up employment; and expanding health coverage and reducing or eliminating user charges for low-income households.

It is also important to keep in mind that the expansion of public spending needed to pursue redistributive fiscal policies may jeopardize fiscal sustainability in some circumstances. This implies that policies such as South Korea's basic old age pension, Thailand's price subsidy for rice farmers, and India's food subsidy need to be well calibrated. Asian countries must strengthen their revenue base, rationalize subsidies, and target social and infrastructure spending to make sure that their impact is both growth-friendly and pro-poor. In particular, education and health, both areas in which government spending is relatively low in developing countries in Asia, may need more public support.

Monetary Policy

Although the role of monetary policy in addressing inclusive growth has received relatively little attention in the economics literature, our empirical results suggest that policies should aim for longer-term macro stability rather than trying to generate temporary booms. On the one hand, expansionary monetary policies can help lower unemployment, which, as the model also suggests, would contribute to inclusive growth. However, the cyclical effects of monetary policy on unemployment are inherently temporary and furthermore, expansionary monetary policies also generate inflation, which according to the estimates has negative effects on inclusive growth. The estimates also suggest that lower GDP volatility is a key determinant of inclusive growth. The combined impact of these variables implies that monetary policies which seek to keep inflation low and aggregate demand stable are best for inclusive growth. Currently, observed inflation and GDP volatility in the region are not particularly worrisome on average; however, Asian policy makers should stand ready to act in case problems materialize in the future.

Structural Reforms

In addition to fiscal and monetary policies, more long-term structural policies are needed for inclusive growth. Zhuang et al. documented how key drivers of rapid growth — such as technological progress, globalization and market-oriented reforms — have also increased inequality in developing Asia by favoring skilled over unskilled labor, capital over labor, and urban and coastal areas over rural and inland regions. They concluded that, in order to soften the negative aspect of those changes, Asia needs effective labor market and industrial competitiveness policies to create productive jobs for a wide section of the population, so that growth can be sustainable and inclusive. On the other hand, the IMF has found that trade globalization is associated with a reduction in inequality, as opposed to financial globalization which is associated with an increase in inequality ("World Economic Outlook: Globalization and Inequality", *IMF Paper*, 2007). This would seem to suggest that a policy of careful sequencing, in which barriers to trade are reduced before complete financial account liberalization, would allow the benefits of globalization to be shared more equally.

Our empirical findings are in line with the above arguments, which suggest the need for labor market and trade policies for inclusive growth. First, the results have stressed that labor market reforms to reduce unemployment and increase competitiveness by raising productivity are important for inclusive growth. The unemployment rate in developing countries in East Asia and the Pacific is relatively low, at around 4% on average in 2012, compared to other developing countries so there may not be much scope to act there. On the other hand, developing Asia's productivity, as measured by GDP per person employed, is still low and there is scope to improve labor productivity in general *(Chart 5)*.

Second, the results also imply that further increasing trade openness would be beneficial in terms of growth inclusiveness. Trade openness in the region, measured by the sum of exports and imports as a percentage share of GDP, ranges from about 50% in Indonesia and China to about 150% in Thailand and Malaysia. A comparison of the level of trade openness in East Asia and the Pacific with that of other parts of the world suggests that there is some more room to improve trade openness, since the level of openness in the region as a whole is lower than in Sub-Saharan Africa and in Europe and Central Asia. One policy implication is that completing negotiations for various bilateral and multilateral trade talks in which several Asian countries are involved, such as the Regional Comprehensive Economic Partnership (RCEP) and the Trans-Pacific Partnership (TPP), would be beneficial for inclusive growth. JS

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