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Have economic growth and institutional quality contributed to poverty and inequality reduction in Asia?

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ABSTRACT

While economic growth has been cited as one of the main factors behind the reduction in absolute poverty, the persisting problem of poverty in developing countries has raised doubts about the efficacy of economic growth in its reduction. Recent evidence revealed that growth in Asia has been accompanied by an increase in relative poverty, or income inequality. High income inequality can slow the rate of poverty reduction, and create social unrest and anxiety. The quality of institutions may also influence the extent to which economic growth reduces poverty. This study examines the effects of economic growth and institutional quality on poverty and income inequality in nine developing countries of Asia for the period 1985–2009. The System Generalized Method of Moments (GMM) estimation method is employed to estimate the equations. While economic growth does not appear to have an effect on income inequality, the results confirm that such growth leads to poverty reduction. Although improvements in government stability and law and order are found to reduce poverty, improvements in the level of corruption, democratic accountability, and bureaucratic quality appear to increase poverty levels. Similarly, the results also show that improvements in corruption, democratic accountability, and bureaucratic quality are associated with a worsening of the income distribution. This study recommends that measures taken to improve the level of institutional quality in developing countries of East and South Asia should address the problems of poverty and income distribution, while adopting policies to support informal sector workers who may be affected by institutional reform.

1. Introduction

South Asia, comprising Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka, has been growing rapidly in recent years. According to the World Bank, the GDP per capita growth rate for South Asia in 2007 before the global financial crisis was around 7.5%. Growth in developing countries of East Asia (Brunei, Cambodia, China, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand, and Vietnam) has also been remarkable, with an average GDP per capita growth rate of 6% in 2007, based on World Bank calculations. Data also shows a clear upward trend in GDP per capita in East and South Asia during the period examined in this study (1985–2009). However, despite its remarkable development over the past few decades, poverty levels in South and East Asia remain very high. Therefore, poverty reduction has taken center

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stage in the development debate, as the Millennium Development Goal of halving the proportion of people living on less than \$1 a day by 2015 draws closer.

Among the remedies for improving the poverty situation is economic growth, which has been widely cited as being significant in improving the lives of the poor (Adams, 2004; Balisacan, Pernia, & Asra, 2003; Dollar & Kraay, 2002; Kraay, 2006). Many economists argue that economic growth, through increasing per capita incomes or expenditures, can ameliorate the situation of the poor (Adams, 2004; Balisacan et al., 2003; Dollar & Kraay, 2002; Kraay, 2006). However, this view has been subject to debate for many years as other researchers have contended that growth and globalization have led to increasing income disparities, thereby impeding the rate of poverty reduction (Ravallion, 2001; Ravallion & Chen, 2007). Hence, it is important to re-examine the relationship between economic growth and poverty in the context of the recent debate on this issue.

As well as re-examining this relationship, it is also imperative to analyze changes in relative poverty or income inequality. Kuznets (1955) investigated the relationship between economic development and inequality and found that early stages of development of an economy are characterized by rising inequality, while later stages are associated with lower levels of inequality. This hypothesis suggests that inequality may be rising in developing countries, as these countries are experiencing early stages of economic development. Although several scholars have repudiated this finding (Anand & Kanbur, 1993; Ram, 1989), attention has recently been paid to rising inequality within countries, especially in the Asian region (ADB, 2012). Rising inequality is harmful for several reasons. Higher income inequality leads to slower economic growth, particularly in populous countries like China, since greater income inequality can limit the growth of mass demand (Wade, 2004). Higher inequality also implies that the poor receive a lesser share of the gains from economic growth (Ravallion, 2009). If inequality had remained stable in the Asian economies that in reality had witnessed an increase, the same growth in 1990–2010 could have lifted about 240 million more people out of poverty (ADB, 2012). Finally, income inequality might induce the poor to engage in disruptive activities such as crime and riots, creating social unrest and anxiety (Barro, 2000).

At the same time, it is also possible that the rate at which poverty reduces is affected by the quality of institutions in East and South Asian countries (Chong & Caldéron, 2000a; Chong & Gradstein, 2007; Tebaldi & Mohan, 2010). This study defines institutions as the formal and informal 'rules of the game' of a society (Hasan, Mitra, & Ulubasoglu, 2007; Tebaldi & Mohan, 2010). According to Sala-i-Martin (2002), the measures of institutions should encompass the enforcement of contracts, protection of property rights, the predictability and effectiveness of the judiciary system, the level of corruption, the level of transparency of the public administration, and pro-market regulations. This current study uses five subjective measures of institutions, in line with studies by Chong and Caldéron (2000a, 2000b), Chong and Gradstein (2007), Hasan et al. (2007), and Tebaldi and Mohan (2010). These measures are: government stability; corruption (in government); law and order; democratic accountability; and bureaucratic quality. The definitions of these measures are given in Section 3.1.

Institutional quality is said to influence the level of poverty through market inefficiencies and misallocation of resources (Tebaldi & Mohan, 2010). Keefer and Knack (1997) maintained that poor institutional quality undermines the security of property rights. Taking bureaucratic quality as an example, the poor quality of administrative officials coupled with few institutional restrictions on them lead to greater error in administrative decision-making. This lowers the predictability of government decision-making, thereby reducing the security of property and contractual rights (Keefer & Knack, 1997). Uncertainty with regard to property rights can deter foreign investment and lead to lower economic growth, which in turn may lower the rate at which poverty is reduced. Weak institutions can have a detrimental effect on inequality as well (Chong & Gradstein, 2007; Chong & Caldéron, 2000b). For example, the beneficiaries of tax evasion and tax exemptions (as a result of corruption) are most likely to be relatively wealthy, which means that almost the entire tax burden falls on the poor (Andres & Ramlogan-Dobson, 2011). While most studies have examined institutional quality and its effect on poverty and income inequality for countries across several regions, empirical research on the Asian region is lacking. Thus, examination of a particular region is important, as there could be regional and cultural differences in the nature of institutions.

The purpose of this study, therefore, is to examine the effects of economic growth and improvements in the quality of institutions on poverty and income inequality in East and South Asia, for the period 1985–2009, using the system Generalized Method of Moments (GMM) estimation method. The analysis is conducted for nine developing countries in the region – China, Indonesia, Malaysia, Philippines, and Thailand (East Asia), and Bangladesh, India, Pakistan, and Sri Lanka (South Asia). Specifically, this study aims to answer the following questions:

1. To what extent has economic growth led to a reduction in poverty in East and South Asia?
2. Does economic growth lead to higher income inequality?
3. Has the level of institutional quality had an influence on poverty reduction?
4. What is the effect of institutions on income inequality?

The rest of this paper is organized as follows. Section 2 examines the levels of poverty, inequality, and institutional quality in East and South Asia, as well as the past and present literature on the relationships between growth, institutions, and poverty and inequality. Section 3 presents details of the data used and the econometric approaches employed in the present study. Empirical findings and the analysis and discussion of the results are presented in Section 4. The paper concludes with a summary of the research findings and policy recommendations.