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BOOK REVIEW

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PRE

The Philippine Review of Economics

A joint publication of the UP School of Economics (UPSE)
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Book Review

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Raul Fabella. *Capitalism and inclusion under weak institutions*. 2018. ISBN 9789717421162 Quezon City: UP CIDS

1. Inequality and growth

The book tackles the issues of inequality and growth, acknowledging the widely-held belief that there is a trade-off between inequality and growth. In his seminal paper in 1955, Simon Kuznets observed that a developing country experiencing economic take-off will likely first undergo increasing inequality, after which this tapers off and eventually declines as the country reaches higher levels of economic development [Kuznets 1955]. Kuznets' Inverted U Hypothesis has become received wisdom for decades, producing economists that tend to tolerate (or perhaps even celebrate) rising inequality with the view that this is the "price nations pay" for economic growth and development. (See also Acemoglu and Robinson [2002]). Dr. Fabella himself boldly lays out this view. Referring to China's proliferation of billionaires, he notes: "…the 'Jack Ma phenomenon' may be argued to have helped rather than impede poverty reduction in China. If so, I call it a fair exchange". [Fabella 2018:4]

As an aside, let me be clear that I know Dr. Fabella to appreciate the deep challenge that is inequality and poverty in the Philippines. Indeed, my critique is directed at our entire profession for apparently failing to push more effectively on equity and redistribution issues, compared to efficiency-enhancing reforms. Some call this a bias among economists, this writer included. Yet even in our discipline, the emerging evidence suggests the need for a much sharper view.

Advances in the empirical literature revealed a largely mixed evidence base on the Kuznets curve. For instance, International Monetary Fund economists Andrew Berg and Jonathan Ostry [2011] empirically analyzed 140 countries spanning 1950s to 2000s in order to determine whether and to what extent inequality affects long run growth. They noted how higher income inequality may trigger social unrest and/or bar the poor from human capital accumulation, contributing

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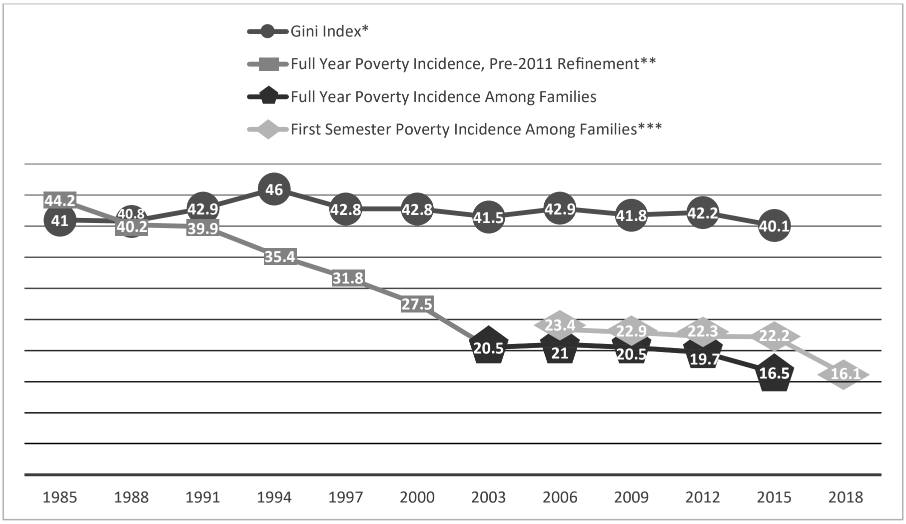
to shorter growth episodes. Dr. Fabella noted that, notwithstanding these findings, he believed that "sustained growth leading to less income inequality is more compelling" [Fabella 2018:3], further emphasizing his faith in the other half of the Kuznets curve.

In the Philippines, the story has been more of a "double whammy"—a failure to reduce poverty more aggressively, even as inequality dramatically increased. (See Figure 1.) The end result is that the Philippines was ranked, globally, in the bottom half of most unequal countries in the 1980s, and today it is ranked in the top third of countries in inequality [Mendoza 2019].

FIGURE 1. Poverty incidence and income inequality (Gini index) in the Philippines, 1985-2015/2018



Source: Data from the Philippine Statistics Authority and World Bank's World Development Indicators.
Notes:
* Gini index measures the extent to which the distribution of income or consumption expenditure among individuals or households within an economy deviates from a perfectly equal distribution.
** In 2011, poverty statistics were refined to reflect changing phenomena in Filipinos' quality of life (NEDA, 2011). Refinement covered statistics from 2003 onwards.
*** The first set of first semester official poverty statistics only covered the years 2006, 2009, and 2012.

Even within the Philippines, across geographic regions, inequality is quite stark. In its recent analysis of economic growth across regions, the National Economic and Development Authority found evidence of divergence across regions, across time. Richer regions grew faster than poorer regions, signaling a growing development gap between the country's rich regions compared to its poorest ones [Domingo 2019]. Development outcomes have become so divergent that some parts of Mindanao are mired in human development levels comparable to conflict-prone African countries. The National Capital Region, on the other hand, achieved human development levels at par with Thailand, a fast-growing

East Asian economy. Disparities in life expectancy further underscore the regional inequality. A Filipino child born in Tawi-Tawi can expect to live up to 54 years of age—a full 19 years shorter than the national average and 24 years shorter compared to children living in La Union province [Banaag, Dayrit, and Mendoza 2019]. If Americans have a saying that some are born on the "wrong side of the tracks", perhaps we Filipinos will soon have a saying that millions are born on the "wrong island": Luzon being the best place to be born in terms of human development prospects, and Mindanao the complete opposite.

2. The "n word"

If these various dimensions of inequality are well known and are by now quite stark, why the seeming inaction? Is there a bias for efficiency over equity in the economics profession? And is this deeply engrained not just in the way we teach economics (and our next generation of economic thinkers), but also in the way we advocate for certain reforms?

These questions remind me of how trade liberalization appears to have been pushed in the country. Rice tariffication is the latest example. The caricature of economists is that we push hard on efficiency-enhancing liberalization and deregulation reforms—and yet we fail miserably in pushing for the collective action to support the domestic supply side response for more Filipino sectors to compete better and participate more effectively in the market economy. Hence, we tend to be branded as "neoliberals"—in some circles, a highly derogatory term which seems to complement the caricature of the "heartless economist". Few of us even talk about the redistributive implications of these types of reforms—and in some cases, some of us even celebrate the resulting inequality as part of the inevitable bargain for more economic growth (i.e., my point earlier).

Yet this "n word" is really only earned because of our profession's seeming continued failure to push not just for liberalization, *but also more importantly* the protective and capacity-building reforms, including the institutions to better regulate the market economy in ways that promote strong competition and fairness. For instance, a few months after the rice tariffication law was passed, there are reports of Filipino farmers facing stiff competition from imports and a steep decline in farmgate prices. And even as these reports surfaced, at the time of writing this article, the Department of Agriculture still does not have a game plan let alone a fully committed Department Secretary during this critical period of adjustment to competition. If economists pushed hard to open up the rice sector to competition, then why aren't we pushing for better governance in the agricultural sector and a more robust plan to boost the supply side? I recall attending farmers' meetings in the National Food Authority wherein they critiqued economists for promising large foreign markets and significant benefits from trade liberalization in the 1980s—only to be frustrated by the influx of agricultural produce from other countries while themselves failing to penetrate foreign markets. Today, could we be earning the "n word" critique all over again?

3. Lessons from China?

Dr. Fabella also devoted further ink to emphasize the lessons learned from China, a country that managed to reduce poverty and yet experienced a dramatic rise in inequality. Perhaps China will continue to look good for as long as it lowers the "cost" of its growth-inequality trade-off by successfully avoiding risks of a political crisis (so far). We can acknowledge of course how China has managed a dramatic improvement in its economic status in the last three decades, yet more recently it is critical to note that China has taken some rather risky political reforms.

In a vote to amend the constitution, the National People's Congress allowed President Xi Jinping to remain in power for life after successfully abolishing the two-term limit for the presidency and vice presidency. There are various possible explanations. One notes how President Xi's move to abolish term limits may have been motivated by factionalism in the Chinese Communist Party. (See, among others, Chan [2018] and Kojima [2015].) The ability of President Xi to push through with this decision is a manifestation of his strong grip over the Chinese Communist Party. However, critics also state that this pressing need to hold onto power is also proof that he has to keep his opponents at bay.

Analysts have since critiqued China for going in the "wrong direction" as far as political reforms, even as its growing inequality has exposed many cracks in their social and economic landscape. The "Chinese dream"—a vision of a cohesive, equal society, increasingly wealthy and healthy, and happily wedded to Communist Party rule, ardent patriotism, and traditional values—is President Xi's campaign to address China's growing inequality gap. Studies reveal that despite maintaining allegiance to the status quo, citizens still face income inequality and discontent in school and health care services [Buckley 2016]. Data also reveal that in spite of the increasing number of Chinese billionaires, 30.46 million Chinese still continue to live in poverty [Jennings 2018]. Notwithstanding China's dramatic reduction in poverty over the last 30 years, this country has also become one of the most unequal in the world.

Acemoglu and Robison [2002] note that "the decline in inequality was an outcome of political changes forced on the system by the mobilization of the masses". China's highly authoritarian and repressive political system has so far been able to suppress this—but for how much longer? Witness the growing protests in Hong Kong against the proposed extradition law and the defiance of Taiwan against Chinese militarization in the South China Sea in recent months.

Clearly, China may have important development and poverty-reduction lessons to share; but its tolerance of inequality and its recent moves to further concentrate political power in the hands of a few are probably not among them. In the case of the Philippines, tolerating further inequality in the interest of continued robust growth remains a risky path forward. The international literature appears to support this; but one has to turn to a wider set of disciplines to uncover the evidence on the full picture.

4. Economists and hammers

Mark Twain was reputed to have said, "To a man with a hammer, everything looks like a nail". He might as well have referred to an economist. The multi-dimensional nature of inequality suggests that an economic lens alone will probably be insufficient. To better understand and appreciate the challenge that is inequality, a much broader analytical toolkit is probably necessary. Political science and sociology offer some useful insights here.

For instance, Bollen and Jackman [1995] examined Muller's [1995] conclusion that income inequality has a major impact on democratization. They argued that "democracies are less stable in societies that are more unequal to begin with, in societies in which household income inequality increases…and in societies in which labor receives a lower share of value added in manufacturing" [1995:987].

Other analysts have emphasized how inequality produces political instability and democratic regress. Boix [2003] noted how "higher inequality reduces the propensity of a society to democratize". Alesina and Perotti [1996] found empirical evidence that "greater inequality leads to greater political instability". Dutt and Mitra [2008] noted how highly unequal countries tend to oscillate between democratic and autocratic regimes.

Research by Corak [2016] emphasizes how the inequality of starting points across generations becomes more skewed as the intergenerational earnings elasticity—a measure of how much wealth is passed on from one generation to the next—becomes stronger. (See Figure 2.) The pattern suggests that countries with higher inequality also have larger differences in "starting points" within their respective populations (e.g. earnings mobility is weaker in countries with higher income inequality).

FIGURE 2. Cross plot showing the direct association between intergenerational earnings mobility and inequality

Source: Corak [2016]

Even turning to the health sciences literature, studies of the cognitive abilities of children born from parents suffering from poverty reveal how poverty begets poor human capital development, which in turn consigns the next generation into continued poverty [Shepherd and Brunt 2013]. In addition, living in poverty itself can affect one's cognitive abilities, which in turn can also consign individuals to lower productivity and hence also deeper poverty [Mani et al. 2013]. This emerging evidence suggests a "poverty trap" that is self-perpetuating on the level of the individual. Some of the aspects of inequality which are largely pre-determined even prior to birth signal deep questions as regards the fairness of social and economic systems that perpetuate them [Jackson 2017].

Further multi-disciplinary research digs even deeper on the phenomenon of inequality in many societies by using tools beyond economics. Starmans et al. [2017], for example, turned to laboratory studies, cross-cultural research, and behavioral experiments to reveal evidence that many societies do not abhor inequality per se and that humans naturally prefer fair distributions rather than equal ones. So, it is in fact economic unfairness which is problematic. There is evidence that people prefer fair inequality over unfair equality.

These types of studies underscore how much more multi-disciplinary our analytical tools and evidence base needs to be. In the Philippines, in the context of research on political economy, recent research on political dynasties underscore how political inequality could be critically linked to *both* persistent poverty and inequality in the Philippines. Mendoza et al. [2016 argued that the provinces where dynasties continue to thrive and expand are also considered the poorest in the Philippines. According to their study, the lack of checks and balances and an uncompetitive electoral environment allow these political dynasties to hold onto power even if they are behind the worsening poverty of their constituencies.

Many analysts have since observed that the country is becoming less democratic, as the poorest provinces in the country do not have the power to choose their leaders because of the cultivated dependency on dynastic politicians. More recently, one senator from a well-known political clan even noted how it would be acceptable to have political dynasties as long as elections are fair. Yet, traditional politics in the Philippines is linked to vote buying, political violence, corruption, nepotism, and clan-based (in lieu of party-based) political selection. Clearly, none of these features inspires fairness—and they too paint a risk-laden landscape as far as political stability is concerned [Rita 2018].

5. Terrorists and populists

Political dynasties represent a particular form of political inequality—inequality in access to power. A political landscape riddled with dynasties is less likely to deliver public goods, let alone produce fair economic (and other) trade-offs [Mendoza 2012]. Copious evidence on political dynasties provide evidence—not just in the Philippines but also in other developing country contexts—that this pattern of leadership is associated not with better public services, but with the exact opposite. In fact, the existing literature suggests that political inequality is likely to exacerbate economic inequality; and that the concentration of political power is not channeled towards breaking the concentration of economic power (Acemoglu et al. [2008]; Asako et al. [2015]; McCoy [1994]; Mendoza [2016]; Rossi [2014]). This kind of economic and political power concentration—and the resulting collusion—is rife with rent-seeking and corruption. It is unsurprising that in such environments, trust in government eventually erodes, and so does the social compact. In extreme cases, conflict and terrorism risks emerge.

Recent research on domestic terrorism events suggest that inequality is a key factor driving up the risk of terrorism. Krieger and Meierrieks [2019] analyzed data on domestic terrorism events in 113 industrial and developing countries between 1984 and 2012. They found evidence that higher income inequality is linked to more domestic terrorism events. When they analyzed the main transmission channel between inequality and terrorism, they found evidence of income inequality corroding institutions through corruption, which in turn helped to motivate domestic terrorism. As regards policy options, they found that countries with stronger redistribution also more effectively mitigated domestic terrorism by helping to improve institutions.

Redistribution appears to be more prominent in many countries' economic policy discussions these days for many reasons including globalization and economic integration. Dani Rodrik [2018] lays out the economics of populism in a recent paper that eloquently framed how our profession's main theories—notably the Stolper-Samuelson model which predicted sharp losses as well as gains for distinct groups in a country—should have helped us predict the intensification of the redistributive implications of economic integration. From here, it would be straightforward to anticipate the potential backlash by the most marginalized groups. Rodrik observes how "Economic theory has an additional implication, particularly germane to our discussion, which is less well recognized. In relative terms, the redistributive effects of liberalization get larger and tend to swamp the net gains as the trade barriers in question become smaller. In other words, the ratio of redistribution to net gains rises as trade liberalization tackles progressively lower barriers". Clearly, Rodrik is gently reminding us fellow economists that pushing globalization faster than our institutions could be set up to protect and give sufficient agency to the marginalized generates risks of backlash and, as we see today, populism.

Political institutions are particularly important to give agency to those on the marginalized end of the inequality divide. If they become voiceless and powerless, the ramifications could include populism. Perhaps it is fitting that, as a final note, one should revisit the most recent work of Thomas Piketty, the author acknowledged by Dr. Fabella for raising the issue of inequality. Piketty [2018] recently offered a possible explanation behind the recent rise and prevalence of populists. He argued that economic growth has failed to suppress the growing social and political pushback against some of the received wisdom in economic policy, including international economic integration, more open borders, and freer flows of people, goods, and investments. Linking the pushback to political reality, Piketty further noted how most major political parties have been unable (or unwilling) to address inequality. As pockets of marginalized communities and sectors of society did not find credible allies in traditional political parties, they then sought alternatives.

Thus, the link from inequality to populism—the latter a widespread phenomenon in both rich and poor countries, often with large voting populations disenchanted with globalization—establishes what pushes countries away from sustained growth. Populist policies often favor redistribution without deep and fundamental reforms addressing what caused the inequality in the first place.

Hence, for all these reasons, inequality is of interest not merely because of social preferences for less unequal distribution of wealth. Inequality itself can end growth spurts—raising different risks that transcend the economics sphere and threaten to stop countries on their growth tracks. It is critical to tackle this social challenge, and economists need to step up and upgrade their analytical toolkit and collaborate with a wider set of disciplines.

To conclude, Dr. Fabella's *Capitalism and inclusion under weak institutions* opens the door to revisit the issue of inequality and inclusive development in the Philippines. It certainly provoked this economist to start thinking about the key social, political, and economic challenges of our time and in the near horizon. In the final analysis, because of our profession's disproportionate influence on economic policy, we cannot disentangle ourselves from our country's struggle to emancipate itself from underdevelopment and inequality. The country's continued failure to develop is also, inevitably, our profession's failure.

Success will likely depend on passing important lessons to the next generation of economists. I think of this as a de-monopolization of economic thinking and lenses in the area of development policy reforms. More tools for analysis and more competition of development perspectives is likely a more fertile landscape for development thinking and innovation, particularly if we manage to strengthen evidence-based debate and policymaking. Dr. Fabella does the economics profession in the Philippines a great service by pushing the debate forward.

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