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The Impact of Socio-Economic Inequalities and Political Channels on Economic Growth Through Economic Sanctions in OECD Countries

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Abstract

This study examines the effect of socio-economic inequalities and political channels on economic growth, with an emphasis on the moderating role of economic sanctions in OECD countries. The results of PLS estimation find that in contrast to political stability which has a significant positive relationship with economic growth, socio-economic inequalities and freedom have a significant negative effect on economic growth; and economic sanctions also have a significant effect on the relationships between political variables employed and economic growth. However, the results of the RLS model estimation shows that economic sanctions strengthen the relationship between socio-economic inequalities and economic growth.

Moreover, according to the results of Johansen cointegration test and VAR method, it is concluded that inflation tends to have a significant negative effect on economic growth in long run; while there is a positive relationship between inflation and economic growth in the short run. Furthermore, the conintegration test highlights that there is no long-run relationship between inequality variables and economic growth; although, based on the VAR method, the short-run relationship between women's influence in parliament—as a variable of social inequality—and economic growth is confirmed.

Keywords: Economic inequalities, social inequalities, political stability, degree of democracy, economic growth, economic sanctions

1. INTRODUCTION

Income inequality is a challenge for countries across the world. Existing literature has found that income inequality generally reduces economic growth based on endogenous fiscal policy approaches (Kennedy et al. 2017), socio-political instability (Zhao and Zhang 2005, De Dominicis 2008, and Lu and Nguyen 2019), borrowing-investment in education (Aghion et al. 1999, and De Dominicis 2008), and the joint decision of fertility education (Lu and Nguyen 2019). In the presence of high-income inequality, strikes arise due to the dissatisfaction of the population and the implementation of poor policies that do not serve the interests of the entire population. Furthermore, there tends to be corrupt behavior and rentier activities, where the riches influence the law and distribution policies to increase their wealth at the expense of the general poverty. This leads to uncertainty that causes low domestic and foreign investor confidence and

hence a fall in growth in the long run (Barro 2000). Some studies model the income inequality-growth relationship from the social and political perspective. They found that high-income inequality negatively affects growth through social-political unrest. This is because economies with high inequality have high levels of disturbing behaviour, such as criminal activities, strikes and other unproductive activities that lead to wastage of government resources and political instability (Barro 2000, and Benhabib and Rustichini 1996).

In contrast, some studies have demonstrated that an increase in social and political unrest can lead to the promotion of fair income distribution. To reduce the number of riots, politicians welcome redistribution—from the rich to the poor—in a transfer of payments. It will restore the people's trust in government, and improve investment, thereby enhancing growth in the long run (Barro 2000, and Benhabib and Rustichini 1996). Besides, the studies show that income inequality might cause economic growth based on the classical economy approaches of the savings rate (Aghion et al. 1999, De Dominicis et al. 2008, and Shin et al. 2012), the equality-efficiency trade-off (Yang and Grani, 2017), and wealth concentration (Aghion et al. 1999). Additionally, some stcholars, such as Kuznets (1955) found that income inequality varies along economic development stages and technological advancement. Therefore, the relationship between inequality and economic growth is not necessarily positive or negative and this relationship may be uncertain and depend on other. For example, the income level of countries (Yang and Grani 2017, and Novosa 2019) and the population growth rate and investment level (Yin et al. 2006) can affect the relationship between inequality and economic growth.

There is always a two-way relationship between political stability and economic performance. On the one hand, economic factors such as inequality in the distribution of income and wealth, increasing unemployment, increasing inflation and decreasing economic growth affect political stability in countries. As mentioned, political stability is one of the most important factors in the path of economic growth. According to Ake (1974), political stability means the regularity of the flow of political interactions (see also Asgharpur et al. 2014). In contrast, political instability refers to a state of uncertainty that a government faces in terms of how it will govern society, maintain its sovereignty, or maintain the territorial integrity of the country (Komijani 2013). Political regimes can achieve political stability through political legitimacy or through coercion.

One of the most important factors in establishing political stability is the level of public participation in politics, or more precisely, the level of democracy in the country. Economists seek to preserve property rights in democracy, which is one of the main prerequisites for economic growth. Some studies implicitly or explicitly emphasize that in non-democratic regimes, property rights change in favor of powerful individuals and the ruling party, which prevents the free flow of capital in such countries. In non-democratic and authoritarian governments, there is no guarantee that the government will be effective, because the non-democratic government can change the priority from social interests to group interests and reduce the efficiency of allocation and distribution in the economy, and through this channel, slow down economic growth and pave the way for more poverty.

However, this does not mean that democracy and political development can necessarily provide the conditions for economic growth and bring greater prosperity to the nation, which is supported by controversial results obtained from empirical studies on this nexus. In any case, what is certain is that political instability, regardless of its type and intensity, always robs the energy and potential that should be used in the path of economic growth, and distorts the natural course of the economic system due to mismanagement resulting from intra-party and extra-party conflicts, and slows down the pace of economic

growth (Asgharpur et al. 2014).

Regardless of the type of political regime and the degree of development of countries, political unrest has been a concern for many countries in the world in the past decade. The simplest and most effective theory that directly links economic growth to political instability was presented by Huntington. According to Huntington's view, although a relatively higher level of development is accompanied by stability, the development process creates regular tensions and pressures that in turn lead to political instability. Tabellini et al. (1991), and Alesina et al. (1991) have studied the effect of political instability on economic growth. Their research results show that political conflict can have significant effects on the performance of countries' economies. The greatest harm that political instability causes to countries is the loss of life and the reduction of social welfare.

Economic sanctions are one of the most important and common types of sanctions, which aim to reduce the economic power of the target country and prevent it from meeting its needs. Sanctions are carried out with the aim of reducing the production of the targeted country, reducing the value of the national currency and increasing unemployment, increasing prices, government budget deficits and ultimately causing public discontent and creating civil unrest in the targeted country (Nakhli et al 2020). This conceptual framework is supported by empirical studies. The limited empirical evidence concerning the economic effects of international sanctions on target countries suggests that sanctions trigger financial crises (Hatipoglu and Peksen 2018) and reduce income per capita (Neuenkirch and Neumeier 2015)—reductions in trade (Afesorgbor 2019, Crozet and Hinz 2020, and Gutmann et al. 2022), international capital flows (Besedeš et al. 2017), and foreign direct investment (Biglaiser and Lektzian 2011, and Mirkina, 2018) are likely transmission channels—but both can be undermined by sanction busters (Barry and Kleinberg 2015, Early 2015, Haidar 2017, and Lektzian and Biglaiser 2013). Sanctions can also be costly to the sender country, as illustrated by the sanctions against Russia after its illegal annexation of Crimea in 2014 (Bělín and Hanousek 2021, Crozet and Hinz 2020, Gullstrand 2020, and Kholodilin and Netšunajev 2019) or against China after the Tiananmen Square Incident in 1989 (Webb 2020).

Previously, based on the literature and research background, we explained the theoretical relationships between economic inequalities (income distribution), sanctions, political regimes and economic growth. However, the research literature in the field of moderating effects such as economic sanctions on the relationships between political regimes (or socio-economic inequalities) and economic growth is weak. Therefore, to enrich and develop the previous literature, this study examines the effect of socio-economic inequalities on economic growth with an emphasis on the moderating role of economic sanctions based on World Bank data during 2000-2022 in OCED countries using PLS and RLS methods and the VAR model.

2. Research Methodology

This research is considered a semi-experimental study because it used past information to investigate the subject. The present study is a descriptive-correlational study in terms of the nature of the analysis. In this study, the effect of socio-economic inequalities and political channels on economic growth was examined, with an emphasis on economic sanctions. To assess social inequalities, the index of women's influence and diversity in each country's parliament is used, and to assess economic inequalities, the Gini coefficient index was used. Two political channels, namely political stability and the degree of democratic freedom, are also used. To investigate the subject of the research, data related to the aforementioned variables are extracted from the World Bank website for 21 countries during the years 2000-2022. Finally, data are

analyzed in Eviews.10 software using pooled least squares, robust regression and autoregressive model, clustering tests and analysis of variance.

To examine the impact of research variables on economic growth, regression models in equations (1) and (2) must be estimated.

$$\mathbf{Growth_{i,t} = \beta_0 + \beta_1 * Gini_{i,t} + \beta_2 * SG.GEN_{i,t} + \beta_3 * Saction_{i,t} + \beta_4 * Gini_{i,t} * Saction_{i,t} + \beta_5 * SG.GEN_{i,t} * Saction_{i,t} + \beta_6 * LnGPD_{i,t} + \beta_7 * Inf_{i,t} + \beta_8 * Papulation_{i,t} + \beta_9 * TradeOpenness_{i,t} + \varepsilon_{i,t}} \quad (1)$$

$$\mathbf{Growth_{i,t} = \beta_0 + \beta_1 * PV.EST_{i,t} + \beta_2 * Freedom_{i,t} + \beta_3 * Saction_{i,t} + \beta_4 * PV.EST_{i,t} * Saction_{i,t} + \beta_5 * Freedom_{i,t} * Saction_{i,t} + \beta_6 * LnGPD_{i,t} + \beta_7 * Inf_{i,t} + \beta_8 * Papulation_{i,t} + \beta_9 * TradeOPenness_{i,t} + \varepsilon_{i,t}} \quad (2)$$

Where i represents the country i; and t represents the year t. The summary of the research variables is presented by Table 1.

Table 1: Summary of the research variables

Variable	Indicator Code	Type	Obs.
Growth of Economic	Growth	Dependent	529
Gini index	SI.POV.GINI	Independent	432
Proportion of seats held by women in national parliaments (%)	SG.GEN.PARL.ZS	Independent	523
Political Stability and Absence of Violence/Terrorism	PV.EST	Independent	506
Degree of freedom of democracy	Freedom	Independent	529
Sanction	Byccot	Moderator	529
Population growth	Population	Control	529
Inflation	INF	Control	529
Initial GDP per capita (LN form is used)	Ln (GDP)	Control	529
Trade Openness	Trade Openness	Control	529

3. Results

The results obtained from descriptive statistics test show that the average economic growth of the 23 countries studied is 1.28; and the highest economic growth is identified in Ireland with 23.30%, which occurred in 2015. The lowest economic growth rate is allocated to Spain with a rate of -11.60% in 2020. The average, minimum, and maximum Gini coefficients were 31.79, 23.70, and 42.60, respectively, with the minimum value in 2008 in Slovakia and the maximum value in 2010 in Israel. It is also observed that the average inflation rate during the years 2000-2022 for all the countries studied is about 2 percent. The highest inflation rate is about 12 percent, which occurred in Iceland in 2008 and 2009, and during these years, economic growth in this country was very weak, reaching close to -8 in 2009. The lowest inflation rate is about -4, which is related to Ireland in 2009; despite the high GDP, the country's economic growth over this year is low, around -6%. In addition, it is observed that the significance level associated with the Jarque statistic for all variables (except the logarithm of GDP variable) is equal to 0(P-Value <0.05). It

finds that the distribution of the variables, except for the logarithm of GDP, is not normal.
In this study, the Levin, Lin & Chu test was used to examine the stationarity and stationarity of the variables. It is observed that the variables of economic growth, Gini coefficient, economic sanctions, and population growth are significant at the baseline level; and the variables of women's influence in parliament, political stability, logarithm of GDP, trade openness are significant with one difference; and the variables of democracy and inflation are significant with two differences.

Table 2: Estimation of the regression model in equations 1 and 2

	Model1			**Model2**	
	PLS	***RLS***		***PLS***	***RLS***
Variable	Coefficient	Coefficient	**Variable**	Coefficient	Coefficient
C	-1.69 (0.28)	7.694 (0.02)	**C**	8.46** (0.000)	18.13 (0.000)
GINI	-0.03* (0.021)	-0.07* (0.03)	**PV_EST**	0.35** (0.000)	0.41 (0.06)
SG_GEN_PARL_ZS	-0.02** (0.005)	-0.03* (0.049)	**FREEDOM**	-11.97** (0.000)	-12.10** (0.000)
BYCCOT	-0.97 (0.189)	-3.41* (0.031)	**BYCCOT**	-5.74** (0.000)	-3.01 (0.189)
GINI*BYCCOT	0.02 (0.162)	0.07* (0.034)	**PV_EST *BYCCOT**	0.50** (0.000)	0.07 (0.81)
SG_GEN_PARL_ZS*BYCCOT	0.01 (0.109)	0.03* (0.015)	**FREEDOM *BYCCOT**	5.75** (0.000)	3.26 (0.13)
LN__GDP_	0.37** (0.009)	-0.32 (0.28)	**LN__GDP_**	0.32* (0.019)	-0.52 (0.08)
INF	0.17** (0.000)	0.03 (0.70)	**INF**	0.29** (0.000)	0.19** (0.000)
TRADE_OPENNESS	0.32** (0.000)	0.06 (0.76)	**TRADE_OPENNESS**	0.51** (0.000)	0.20 (0.20)
POPULATION_GROWTH	-0.33** (0.000)	-0.11* (0.54)	**POPULATION_GROWTH**	-0.30** (0.000)	-0.08 (0.66)

****: Significant at the 1% level; *: Significant at the 5% level.**

Equation 1 and 2 are estimated using two methods of RLS and PLS. The results of estimating model 1 with both methods show that the variables of Gini coefficient, the level of influence of women in parliament, had a significant negative effect on economic growth (P-Value <0.05). The results of estimating model 1 with the method of the least squares method show that sanctions do not have a significant effect on economic growth either directly or indirectly (P-Value >0.05). However, the results of estimating the model with the RLS method show that sanctions directly have a significant negative effect on economic growth and also this variable significantly strengthens the negative relationship between the variables of socio-economic inequalities and economic growth.
The results of estimating Model 2 using the pooled least squares method indicate that political stability has a significant positive effect on economic growth (P-Value <0.05, r=0.35), while the degree of

democratic freedom has a significant negative effect on economic growth (P-Value <0.05, r=-11.97). The results of estimating Model 2 using this method also show that sanctions have a significant negative effect on economic growth (P-Value <0.05, r=-5.74) and on the other hand, they strengthen the relationship between political channels (political stability and degree of democratic freedom).

Now, as a precaution, to prevent spurious regression in the model 1, a cointegration test will be used to ensure cointegration relationships. Thus, to address the issue of examining the existence of a long-term relationship between variables, the Johansen cointegration test is employed in this study. Based on the results of the Johanson eigenvalue-effect test, there are a maximum of 5 stacked vectors, and the long-run equilibrium relationship between the independent and control variables with economic growth is estimated using the normalized vector of the Johanson test as follows:

$$\mathbf{Growth} = \mathbf{0.002} * \mathbf{SG_{GEN}} * \mathbf{Byccot} - \mathbf{0.009} * \mathbf{LNGPD} - \mathbf{0.012} * \mathbf{INF} - \mathbf{0.16} * \mathbf{TradeOpenness} + \mathbf{0.09} * \mathbf{PopulationGrowth} \quad (3)$$

Table 3: Results of Johansson's cointegration test for long-run relationships between research variables and economic growth

Variable	Model1
	Coefficient (standard error)
SG_GEN*Byccot	0.002 (0.0009)**
LNGPD	-0.009 (0.036)
INF	-0.012 (0.01)
TradeOpenness	-0.016 (0.02)**
PopulationGrowth	0.095 (0.025)

****-: Significant at the 1% level; *: Significant at the 5% level.**

According to the normalized equation, Johansson finds no long-run equilibrium relationship between socio-economic inequalities and economic growth. However, despite and under sanctions, there is a long-term relationship between women's influence in parliament and economic growth. There is also a long-run relationship between trade openness and economic growth. For every one percent change in the TRADE_OPENNESS variable in the long run, the economic growth variable changes by 16 percent. But there is no long-run relationship between other control variables and economic growth.

Table 4: VAR results for the first model (Vector Auto-regression Estimates)

	Model1			Model2	
Variable	Growth(-1)	Growth(-2)	Variable	Growth(-1)	Growth(-2)
Gini	0.16 [0.50]	-0.034 [-1.82]	PV_EST	0.043 [1.04]	0.00003 [0.019]
SG_GEN	2.17* [2.43]	-0.19** [-3.67]	FREEDOM	0.003 [0.59]	-0.0006* [-2.49]
Byccot	0.52* [0.50]	-0.006 [-0.47]	Byccot	0.669* [2.68]	-0.016 [-1.32]

Gini*SG_GEN	17.80* [2.09]	-0.21 [-0.42]	**PV_EST *Byccot**	0.35* [2.10]	-0.012 [-1.36]
SG_GEN*Byccot	23.24* [2.68]	-0.24 [-0.48]	**FREEDOM *Byccot**	0.67* [2.71]	-0.017 [-1.36]
LnGPD	0.03* [2.80]	-0.0002 [-0.25]	**LnGPD**	0.038** [3.70]	-0.0009 [-1.65]
INF	0.86 [1.82]	-0.06* [-2.14512]	**INF**	2.23** [4.29]	-0.238** [-9.05]
TradeOpenness	0.088** [5.65]	-0.004** [-5.38]	**TradeOpenness**	0.082** [5.02]	-0.004** [-4.33]
PopulationGrowth	0.036 [-0.04]	0.013* [2.28]	**PopulationGrowth**	0.099 [0.42]	-0.003 [-0.76]

****: Significant at the 1% level; *: Significant at the 5% level; T-statistics in [ ]**

As the final step, to better understand the short-term behavior of the studied relationship and to examine the dynamics between the model variables in the short term, this study applied VAR method. In this regard, optimal interval of 2 for the both models are picked based on the Schwartz criterion. The results of VAR test indicate that economic inequality (Gini coefficient) does not have a significant relationship with economic growth in the past one year and two years. However, women's influence in parliament (socio-economic inequality) is positively related to economic growth in the past year and negatively related to the second lag of economic growth. Actually, this relationship between socio-economic inequalities and economic growth (in the short term) significantly strengthens over the past two years. Furthermore, imposing economic sanctions cause that the relationship between economic inequality and economic growth becomes significant in the short term (one year); however, this relationship turns to be insignificant for the second lag of economic growth.

4. Discussion and Conclusion

The main objective of the study is to examine the effect of socio-economic inequalities and political channels on economic growth in the presence of economic sanctions. For this purpose, this study first discussed the impact of economic growth in OECD countries under conditions where socio-economic inequalities are important, and then analyzed this issue under conditions where political stability and the degree of democracy of the countries under study are important. This issue is expressed in the form of two regression models. The models are estimated using two methods, PLS and RLS. The results of the PLS method for estimating Model 1 show that socio-economic inequalities have a significant negative effect on economic growth, but economic sanctions do not have a significant effect on the relationships between these variables and economic growth. However, the results of estimating the model using the RLS method show that economic sanctions have a significant negative effect on economic growth and strengthen the relationship between socio-economic inequalities and economic growth.

Besides, the results of estimating Model 2 using the PLS method indicate that political stability has a positive effect and the degree of democracy of countries has a significant negative effect on economic growth. It is also shown that economic sanctions have a significant negative effect on economic growth in the presence of various political channels. In addition, the results obtained from PLS estimation of Model 2 explain that economic sanctions significantly strengthen the relationship between political channels and

economic rejection. It means that economic sanctions can significantly strengthen the positive relationship between political stability and economic growth, and on the other hand, they can also strengthen the negative relationship between the degree of democracy and economic growth. However, using the RLS method for estimating this regression model does not confirm the significant effect of economic sanctions on the relationship between political channels and economic growth (P-Value>0.05). It is also observed in the both models that in the presence of socio-economic inequalities and political channels, inflation and trade openness cause a significant increase in economic growth; while population growth has a significant negative effect on economic growth.

It is worth noting that the results of the Johansen cointegration test state that, in the presence of independent variables of research and economic sanctions, inflation tends to have a significant negative effect on economic growth in long run. Furthermore, the conintegration test highlights that there is no long-run relationship between inequality variables and economic growth; although, based on the VAR method, the short-run relationship between women's influence in parliament—as a variable of social inequality—and economic growth is confirmed. The VAR results also find that, in the presence of political channels, economic sanctions not only have direct a significant relationship with economic growth, but also strengthen the one-year short-term relationship between economic inequalities and economic growth. To sum up, it is observed that although social inequalities (women's influence in parliament) significantly affect the level of economic growth and this impact can strengthen in long run by imposing sanction; therefore, social policies toward improving equality, such as increasing women's influence in parliament, provide a better and more transparent mechanism for production and factors affecting economic efficiency. It is while the results do not provide a strong argument—especially in the long run—regarding the effect of economic inequalities and political channels on economic growth in developing countries; this issue could have various reasons. Perhaps it can be said that the presence of opposing variables (sanctions, inflation) in the research models has neutralized the effect of independent and important variables on economic growth. Eventually, the long run and short run analyses of variable Trade Openness explain that adopting appropriate international trade policies pave the path toward achieving a higher economic growth level. In addition, making close relations with traders and intermediary trading companies of neighbor countries can be a helpful remedy for treating the distractive effects of sanction on economic growth rate of the country.

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