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Procedia - Social and Behavioral Sciences 35 (2012) 389 – 397

Procedia
Social and Behavioral Sciences

AicE-Bs 2011 Famagusta

Asia Pacific International Conference on Environment-Behaviour Studies, Salamis Bay
Conti Resort Hotel, Famagusta, North Cyprus, 7-9 December 2011

The Impact of CO₂ on Economic Growth in Asean 8

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Abstract

Environmental pollution may directly decrease output and decreasing productivity of man-made capital and labor. The distressfulness and the long term damaging effect of this environmental pollution can contribute to destructive consequences on human wellbeing and economy. The purpose of the study is to examine the relationship between CO₂ on economic growth in Asean 8. The income levels per capita gross domestic product per capita were measured from the year 1965 to 2010. This study formulates a three equation simultaneous model for empirical research. In the pollution indicator emissions, CO₂ in Asean 8, the Environmental Kuznets Curve relationship is found.

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Keywords: Economic Growth; Environmental Kuznets Curve; Hausman Test; Simultaneity, Endogeneity

1. Introduction

Environmental degradation is caused by the following key factors such as industrialization, transportation, population, poverty, soil erosion, congestion and traffic, exploitation of open access resource due to ill-defined property rights, etc, environmental issues must have to be generally adequate taken into account. In Asia, pollutants affect the economic growth. There is a proof of a global nature of air pollution and its effects on Earth's surface. Over a broad region of Asia, from India to China and Indonesia, the evidence showed that emissions of pollutants were becoming entrained in the monsoon circulation and transported into the lower stratosphere (Insciencs 2010). The distressfulness and the long

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term damaging effect of environmental pollution can contribute to destructive consequences on human wellbeing and economy. This will lead to increase in health and social costs. This study attempts to examine the relationship between environmental degradation to economic growth in Asean 8 countries by using the Environmental Kuznets Curve analysis. The focus on environmental degradation is on air pollution measures Carbon Monoxide (CO₂). The primary human source of carbon dioxide (CO₂) in the atmosphere is from the burning of fossil fuels for energy production and transport. (Greenpeace, 2009).

The general objective of the study is firstly to examine the relationship between CO₂ and economic growth in Asean 8 and secondly is to make improvements in the EKC model through an extension and introduction of simultaneity of variables. Pollution may directly decrease output by decreasing productivity of man-made capital and labor. Here, pollution plays as a negative externality. Because of health problems there are losses of labor day; because of polluted air or water there are deteriorations in the quality of industrial equipment. Secondly, the firm's production costs are increased when firms abate pollution emissions. This study contributes to the available literature on EKC by modifying and extending the model to include some additional variables. This study also contributes to the available literature on the use of simultaneous equation methods in such studies. This study formulates a simultaneous equations method by adding the population density as one of the endogenous variable. In fact, population density is also endogenous to the system, being affected by pollution through impacts on health and people die through disease such as lung cancer.

2. Literature Review

The first to model the relationship between environmental quality and economic growth was Grossman and Krueger (1991). At higher levels of income, they found that it has reduced with per capita GDP. For these two indicators of environmental quality, these determinations were depicted statistically as an evidence for the existence of an EKC relationship. Shafik et al (1992) tested the relationship between various key indicators of environmental quality and economic growth and found a systematically significant relationship between income and all indicators of environmental quality. The EKC development has been searched further by Hettige et al (1992). The existence of an EKC relationship for toxic intensity per unit of GDP found in the outcomes of the study. Suri and Chapman (1998) found that as incomes increase and development precedes the world-wide diffusion of manufacturing leads to environmental betterments. A study by Goklany (2001) found that open developing economies improve their environments. This argument has been remarked also by Grossman and Krueger (1991). Managi (2006) stated that economic growth and the decrease of environmental degradation are compatible in accordance to the Environmental Kuznets Curve (EKC) hypothesis. It has been suggested that an inverted U-shaped relationship between economic performance and environmental pollution, empirically, an economy is associated with smaller levels of pollution after some threshold income point. Markandya et al (2006) studied the association between per capita GDP and sulfur emissions for twelve Western European countries. The investigation also searched at the effect of air pollution regulations on the pattern of income and pollution relationship. The study found an inverted U-shaped relationship between income and pollution. Based on the EKC hypothesis, Song et al (2008) investigated the relationship between economic growth and environmental pollution in China. The findings indicate that although there is an inverse N-shaped relationship for waste water in terms of coefficient estimates, all pollutants are inverse U-shaped.

3. Theoretical Framework and Model Specifications

Air pollution was measured in terms of Carbon Monoxide (CO₂). The income levels Gross Domestic Product per capita was measured for the period 1965 to 2006. Income influences environmental quality both directly and indirectly because pollution is the by-product of industrialization and growth (Hung and Shaw, 2004). Based on the study by de Bruyn (2000) and Lopez (1994) there are multiple effects of pollution on production. The former Environmental Kuznet Curves were simple quadratic functions of the levels of income. However in this study we are using simultaneous equations. A study by Stern (1998) stated that where simultaneity exists, use of ordinary least squares to approximate single equation relationships might give a biased and erroneous estimate. In order to approximate the reliable environment-income relationship it is, therefore, more appropriate to employ simultaneous equation model. De Bruyn (2000), however, noted that because of the difficulty in model specification and getting the needed data, the simultaneous relationship between economic growth and environmental quality has not been employed by any empirical studies so far. Therefore, in order to estimate the relationship between air pollution and GDP per capita in Asean 8 countries this study also applies the simultaneity model of income and the environment in line with its structural relationship. For capturing this simultaneous relationship, three equations have been formulated in this study. These are i) pollution equation, ii) income equation and iii) population density equation. By using simultaneous approach and additional variables in these equations, the present study therefore, has developed an improved model to study the relationship more closely to conclude if it follows the Environmental Kuznets Curve (EKC) in Asean 8 countries. Air pollution has been treated as a function of economic growth (Y) and population density (PD). Constituents of air pollution considered are Carbon Monoxide. Therefore, it forms the following model:

$$CO = f(Y, PD)$$

In this model, pollution and population density have been assumed to have any simultaneous effect. Equations of the model are:

Equation 1: Air Pollution (Pollutants) = f (Income, Population density)

Equation 2: Income (Y) = f (Pollutants, Labour, Government expenditure, Foreign Direct Investment, Fixed capital, Net export)

Equation 3: Population density (PD) = f (Pollutants)

Equations (1), (2), and (3) designate the simultaneous equations for this model.

$$\text{Log } CO_{it} = \alpha_0 + \alpha_1 \log Y_{it} + \alpha_2 (\log Y_{it})^2 + \alpha_3 (\log Y_{it})^3 + \alpha_4 \log PD_{it} + \epsilon_{it} \quad (1)$$

$$\text{Log } Y_{it} = \beta_0 + \beta_1 \log CO_{it} + \beta_2 \log L_{it} + \beta_3 \log G_{it} + \beta_4 \log FDI_{it} + \beta_5 \log K_{it} + \beta_6 \text{NX}_{it} + \epsilon_{it} \quad (2)$$

$$\text{Log } PD_{it} = \lambda_0 + \lambda_1 \log CO_{it} + \lambda_2 \log Y_{it} + v_{it} \quad (3)$$

i: 46 years
t: time period

Equation (1) represents the air pollution equation, where,

CO_{ti} : air pollutant in year t
 Y_{ti} : GDP per capita in year t
 PD_{ti} : population density in year t

In the pollution equation, whenever the coefficient of the logY is positive, Y² is negative and that of Y³ is negative it indicates the existence of the EKC hypothesis.

Equation (2) represents the income equation, where,

L_{ti} : labour in year t
 G_{ti} : government expenditure in year t
 FDI_{ti} : foreign direct investment in year t
 K_{ti} : fixed capital investment in year t
 NX : net export in year t

Equation (3) represents the population density equation.

Many scholars in Environmental Kuznets Curve (EKC) studies used linear and quadratic as well as cubic equations (Shafik 1994, Moomaw and Unruh 1997, Wu 1998, Friedl and Getzer 2003). The quadratic equation (Y²) means at the initial stage of development when GDP increases environmental degradation increases, and later with further increases in GDP environmental degradation decreases. The cubic equation (Y³) means with further increases in GDP environmental degradation decreases. Therefore, for the EKC to exist, in cubic equation, Y must have the positive coefficient, Y² must have the negative coefficient and Y³ must have the negative coefficient. In case of a quadratic equation, Y must have the positive coefficient and Y² must have the negative coefficient. In order to ascertain the econometric explanation of the model specification, in the simultaneous equation method a Hausman test is used for income endogeneity. Holtz-Eakin and Selden (1995) and Cole et al. (1997) used this test in their studies.

The analysis starts by testing the existence of multicollinearity and heteroscedasticity in which this study executes the following diagnostic-check:

- Multicollinearity correlation test will be used in order to test the multicollinearity problem,
- White test will be used in order to test the heteroscedasticity problem

The exogeneity of the log form of per capita GDP, its quadratic term, its cubic term, and per capita population density in Equation (1) are the next issue the study is interested. The single polynomial equation estimation may generate unfair and not consistent forecasts if an explanatory variable is an endogenous variable. Therefore, this study necessitates an Instrument Variable (IV) method. Thus, use of two-stage least square (2SLS) method is essential. To assure the exogeneity of these two right-hand variables in Equation (1), this study employs a Hausman specification test. If EKC exist, then the per capita Gross Domestic Product at the beginning will have a positive sign and negative sign related with pollution due to the reality that Environmental Kuznets Curve at the beginning stage demonstrates a positive relationship between per capita income level with per capita pollution emission and negative relationship at the second level. Gross Domestic Product used in this study is the total income contributed by all sectors in Asean 8.

Table 1 shows the expected signs of coefficients of independent variables of the model.

Table 1: Expected Signs of the Explanatory Variables of the Models

Equation (1)		Equation (2)		Equation (3)	
Explanatory variables	Signs	Explanatory variables	Signs	Explanatory variables	Signs
Log (per capita GDP)* (Y)	+	Log (pollutant emission)*	-	Log (pollutant emission)	-
[Log (per capita GDP)] ² * (Y ²)	-	Log (labor) (L)	+	Log (income)	+
Log (population density)* (PD)	+/-	Log (govt. spending) (G)	+		
		Log (foreign direct investment) (FDI)	+		
		Log (physical capital)* (K)	+		
		Log (net export) (NX)	+		

* Are also supported by Shen's study (2006)

The data used in this study have been collected in the form of secondary sources. This is including the East Asian 8 Air Quality Data Reports 1965 – 2010 and East Asian 8 Statistics Data Reports. Besides, World Development Indicators online database; International Labour Origination and all the sources have been referred throughout the findings and analysis of the research. In this regard, the monetary terms with regard to GDP, Physical capital, Foreign Direct Investment (FDI) and government expenditure are deflated by the Consumer Price Index (CPI) with the base year of 1987.

4. Analysis and Interpretation of Results

In this chapter, the empirical model has been analysed and their results have been interpreted and discussed. In selecting the equations of the model in this analysis we have used both quadratic and cubic equations for the model. Whenever the cubic term is found statistically insignificant it has been dropped from the equation finally selected. In order to determine the statistical significance of the cubic terms of log (per capita GDP) in all the pollutants, a t test has been applied. Based on the regression test, air pollutant equations cubic terms were found statistically significant. As such the cubic term of log (per capita GDP) for the pollutant was added in the Equation 1.

To determine the existence of multicollinearity correlation test was done. None of the independent variables were found to be correlated with each other. If the correlation matrix, between one independent variable with other independent variable is greater or equal to 0.9, then only multicollinearity problem occurs. (Wulder, 2005) For estimating the heteroscedasticity a White test was performed. The result shows that no heteroscedasticity was found. The error terms for all of the variables in the model have a constant variance or homoscedasticity. The coefficients were not found significant as at 5% level. In respect of the exogeneity of the log form of per capita Gross Domestic Product, its quadratic term, its cubic term, and the population density, the null hypothesis of exogeneity of these variables is statistically rejected, as can be viewed from the outcomes of the Hausman test for exogeneity (Table 2). This means that in the data set of Asean 8, the simultaneous relationship between per capita income and per capita pollutant emission, does exist. We have used the F test as there are more than one endogenous regressors involved (Gujarati, 1995). For panel data, in order to examine which model to be used in the regression, the Hausman specification test is the classical test of whether the fixed or random effects model should be used. This study found that fixed effect one way is the model that to be used. Then, this study proceeds with the likelihood ratio test in order to examine which model should be used, the fixed effect or pooled

model. Again, this study found that fixed effect one way is the model that to be used. The regression results are as shown in the table below.

4.1. Results and Interpretation as shown in Table 2

This estimation was done under simultaneous equation method.

The anticipated EKC's are found to exist in air pollutants CO₂ (coefficient of log Y is +23141576, log Y² is -76.86276 and log Y³ is -7.12000).

Positive significant relationship for the population density with CO₂ (coefficient of 5903189, t-statistic = 23.14727). This suggests that the higher the population density in Asean 8, is the greater pollution will be emitted. This is consistent with the expectation.

Contribution of endogenous variables on air pollution:

Income contribution: As income increases by 1%, air pollution indicator CO₂ increases by 23141576%, then decreases by 76.86%, and after that decreases by 7.12%. This is following the theory that as income increases pollution also increases at the early stage and decreases at the latter stage. Population density contribution: Population density contribute to a higher pollution in Asean 8 in which as population density increases pollution also increases for CO₂.

Table 2: Estimated Regression Results for Air Pollutants and Income (Eq-1)

	Dependent variables	
Independent variables	Simultaneous equations	
	CO ₂	
Intercept	1.680000(2.424626) **	
Log Y(per capita GDP)	23141576 (8.070940) ***	White 1.3258
Log Y ² (per capita GDP) ²	-76.86276 (-7.874545) ***	White 1.0583
Log Y ³ (per capita GDP) ³	-7.120000 (-7.238231) ***	White 0.5236
Log PD (population density)	5903189. (23.14727)***	White 0.8245
Adjusted R-square	0.837462	
Hausman Test for exogeneity for GDP per capita (F-statistic)	68.42560***	
Hausman Test for exogeneity for GDP population density (F-statistic)	527.5233***	

Note: 1. t-statistics in parentheses. 2. *** represents P<0.01; **, P<0.05; *, P<0.1.

4.2 Results and Interpretation as shown in Table 3

Most of the approximated coefficients are coherent with the anticipated signs and significant. CO₂ indicates negative relationship with income (coefficient of -2.2700) and has a significant effect on income (t-statistic of 12.9476). This suggests that as pollution level increases income reduces and it is coherent with the theory. This indicates that CO₂ is one of the primary contributors of air pollutants that decreases income in Asean 8 and are primarily arriving from industrial activities. The normal inputs such as labor (coefficient of 0.025132, t-statistic = 27.85949) and physical capital (coefficient of 0.190461, t-statistic = 2.842211) are positively and significantly related to the Gross Domestic Product in the income equation. The share of human capital in production is significant (t-statistic of 27.85949) on income in the model. This shows that labor is an important factor in production. The coefficient of government expenditure

shows a positive relationship with income (coefficient of 0.1559) and is highly significant effect on income (t-statistic of 6.7033). Foreign direct investment has a positive relationship with income (coefficient of 0.538743) and has a significant effect on income (t-statistic of 13.94529). Foreign direct investment also has a positive relationship with income (coefficient of 0.5871) and has a significant effect on income (t-statistic of 8.1197). This shows that government spending, foreign direct investment and net export are important factors in increasing the income of Asean 8.

Table 3: Estimated Regression Results for Income and Air Pollutant (Eq-2)

	Dependent variable	
Independent variables	log Y (GDP)	
Intercept	-153371.7 (-23.41941)***	
Log CO ₂	2.270000(12.94762) ***	White 0.0587
Log L (labor)	0.025132 (27.85949) ***	White 0.1569
Log K (physical capital)	0.190461 (2.842211) ***	White 1.3369
Log G (government spending)	0.155918 (6.703342)***	White 1.0059
Log FDI (foreign direct investment)	0.538743 (13.94529) ***	White 0.4600
Log NX (net export)	0.587113 (8.119697) ***	
Adjusted R-square	0.949133	

Note: 1. t-statistics in parentheses. 2.*** represents $P < 0.01$; **, $P < 0.05$; *, $P < 0.1$

4.3 Results and Interpretation as shown in Table 4

The coefficient of air pollution indicator shows a significant effect (t-statistic of 21.4763 for CO₂) on population and it having a negative relationship (coefficient of -1.250000). This indicates that the higher the pollution is the lower the population density. The relationship between income and population density shows a positive relationship (coefficient of 0.7521) and significant effect (t-statistic of 6.2807) of income on population density. This indicates that people with higher income afford to have more family members compared to people with lower income.

Table 4 Estimated Regression Results for Population Density (Eq-3)

	Dependent variable	
Independent variable	log PD	
Intercept	23060.15 (2.265343)**	
log CO ₂	-1.250000 (-21.47628) ***	White 0.8723
log Y	0.752107 (6.280713)***	White 1.9826
Adjusted R-square	0.856978	

Note: 1. t-statistics in parentheses. 2. *** represents $P < 0.01$; **, $P < 0.05$; *, $P < 0.1$.

5. Conclusions

The air pollution (CO₂) has been empirically tested for the case of Asean 8 using econometric models and simultaneous equation method. The hypothesis relates to whether CO₂ in Asean 8 do or do not contribute to and economic growth and do or do not follow EKC theory. In the course of fulfilling the research objectives of this study, various econometric tests have been employed such as Hausman test. In this section, the study summarizes the findings of the objectives as follows. The test shows that there exist simultaneous relationship between CO₂ of air pollution and income. Thus, the two stage least square method will be employed. Thus, the EKC hypothesis is supported by the cases of air pollution CO₂ in Asean 8. Based on the result, CO₂ shows negative significant relationship with income. This is following the theory that as pollution level increases income decreases in which pollution may directly decrease output by decreasing productivity of man-made capital and labor. Because of health problems there are losses of labor day; because of polluted air or water there are deteriorations in the quality of industrial equipment. The coefficient of air pollution indicator shows a significant effect on population density and CO₂ having a negative relationship with population density. This indicates that as pollution increases population density decreases which causes death of a human being in Asean 8.

This study recommends for a future studies to include variables such as solid waste treatment, hazardous waste and noise in the city. Moreover, factors such as Gini index of income distribution can be taken into account to measure the equality of income distribution in Asean 8. Hence, in any of these ways a further extension could be established.

Acknowledgement

I am deeply grateful to Universiti Teknologi Mara Melaka Malaysia and Multimedia University Melaka Malaysia for support to us to complete this paper. I consider myself very fortunate for being able to work with very considerate and encouraging colleagues like Associate Professor Dr.Elsadig and Datuk Associate Professor Dr. Mizan Bin Hitam. Without their offering to accomplish this research, I would not be able to finish it. Their enlightening suggestions and encouragements made me feel I was not isolated in my research.

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